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No. (1)

In the Supreme Court of the United States

COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

ESTATE OF FRAZIER JELKE, III, DECEASED, WACHOVIA BANK, N.A., F/K/A FIRST UNION NATIONAL BANK, PERSONAL REPRESENTATIVE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE ELEVENTH CIRCUIT

PETITION FOR A WRIT OF CERTIORARI

GREGORY G. GARRE
Acting Solicitor General
Counsel of Record
NATHAN J. HOCHMAN
Assistant Attorney General
EDWIN S. KNEEDLER
Deputy Solicitor General
MATTHEW D. ROBERTS
Assistant to the Solicitor General
JONATHAN S. COHEN
RANDOLPH L. HUTTER
Attorneys
Department of Justice
Washington, D.C. 20530-0001
(202) 514-2217

QUESTIONS PRESENTED

1. Whether determination of the fair market value of property for purposes of the federal estate tax, including selection of the appropriate valuation methodology, is a question of fact, reviewed for clear error.

2. Whether the court of appeals erred in holding, as a matter of law, that whenever a company's fair market value for estate tax purposes is determined based on its net asset value, there must be a dollar-for-dollar discount for any built-in capital gains tax liability based on an arbitrary assumption that the company was liquidated on the valuation date.

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ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE ELEVENTH CIRCUIT

PETITION FOR A WRIT OF CERTIORARI

The Acting Solicitor General, on behalf of the Commissioner of Internal Revenue, respectfully petitions for a writ of certiorari to review the judgment of the United States Court of Appeals for the Eleventh Circuit in this case.

OPINIONS BELOW

The opinion of the court of appeals (App., *infra*, 1a-47a) is reported at 507 F.3d 1317. The opinion of the Tax Court (App., *infra*, 48a-84a) is reported at 89 T.C.M. (CCH) 1397.

JURISDICTION

The judgment of the court of appeals was entered on November 15, 2007. A petition for rehearing was denied

on February 21, 2008 (App., *infra*, 85a). On May 6, 2008, Justice Thomas extended the time within which to file a petition for a writ of certiorari to and including June 20, 2008. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(a).

STATUTES AND REGULATIONS INVOLVED

The relevant statutes and regulations are set forth in an appendix to the petition. App., *infra*, 86a-88a.

STATEMENT

1. This case involves the scope of the Tax Court's discretion, as the finder of fact, to select the appropriate methodology to value property for purposes of the federal estate tax. The Internal Revenue Code provides that the value of a decedent's gross estate includes the value at the time of death of all his property. 26 U.S.C. 2031(a), 2033. A Treasury Department regulation specifies that the "value" of that property "is its fair market value at the time of the decedent's death." 26 C.F.R. 20.2031-1(b). The regulation defines "fair market value" as "the price at which the property would change hands between a willing buyer and a willing seller," and states that "[a]ll relevant facts and elements of value * * * shall be considered in every case." *Ibid.*

Another regulation, which specifically addresses the valuation of stocks and bonds, similarly states that, in valuing stocks for which market prices are not available, "the weight to be accorded * * * evidentiary factors considered in the determination of a value depends upon the facts of each case." 26 C.F.R. 20.2031-2(f). A Revenue Ruling that elaborates on that regulation stresses that "[n]o general formula may be given" for determining fair market value, and "all relevant factors affecting the fair market value must be considered." Rev. Rul. 59-

60, 1959-1 C.B. 237, modified in other respects, Rev. Rul. 65-193, 1965-2 C.B. 370.

2. Frazier Jelke, III died on March 4, 1999. At his death, he owned (through a revocable trust) 3000 shares, representing a 6.44% interest, in Commercial Chemical Company (CCC). Since 1974, CCC's sole business has been the investment and management of a portfolio of publicly traded securities for the benefit of its shareholders. In addition to Jelke's revocable trust, those shareholders include several irrevocable trusts, one of which will not terminate until 2019. CCC's shareholders are not allowed to participate in the operation of the business, which is instead managed by CCC's Board of Directors. See App., *infra*, 1a-4a & nn.2-3, 6-7; *id.* at 49a n.2; Tax Ct. First Stipulation of Facts para. 34.

CCC's primary objective is long-term capital growth, and its portfolio performed at just under the rate of the S&P 500 Index during the ten years preceding Jelke's death. CCC has paid substantial cash dividends every year since 1974, in amounts that have increased over time, with a dividend of $33 per share in 1998. CCC's investment policy has resulted in a low asset turnover, which averaged under 6% per year in the five years preceding Jelke's death. CCC's net asset value on Jelke's death was more than $188 million, a large portion of which represented unrealized capital gains. See App., *infra*, 3a-4a nn.6-7, 49a-52a; Tax Ct. First Stipulation of Facts para. 16.

There is no public market for CCC stock, and no private sales occurred during the ten years preceding Jelke's death. At the time Jelke died, CCC's Board of Directors intended to continue to operate CCC as a going concern and had no plans to liquidate a substantial portion of CCC's portfolio at any time in the foreseeable

future. See App., *infra*, 50a-51a; Tax Ct. First Stipulation of Facts para. 48.

3. a. On its federal estate tax return, Jelke's estate valued his CCC stock at $4,588,155. The Commissioner of Internal Revenue determined that the value was $9,111,111, and issued a notice of deficiency. The estate filed a petition in the Tax Court challenging the Commissioner's determination. See App., *infra*, 4a-5a, 52a-53a.

The estate and the Commissioner agreed that Jelke's stock should be valued based on CCC's net asset value. They also agreed that there should be a discount to account for the capital gains tax that would accrue when CCC's assets were liquidated. The estate and the Commissioner disagreed, however, on how to calculate the discount. The estate argued that the discount should be approximately $51.6 million, the dollar-for-dollar value of the capital gains tax that would have been owed if CCC's portfolio had been liquidated immediately on Jelke's death. The Commissioner argued that the discount should reflect the fact that any capital gains tax would actually be paid over a number of years, given the historically low rate of turnover of CCC's stock portfolio. Using that approach, the Commissioner calculated the present value of the likely capital gains tax as approximately $21 million, and he argued for a discount in that amount. See App., *infra*, 53a, 60a, 63a-65a.[1]

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[1] The parties also agreed that there should be additional discounts because Jelke's stock interest did not give him control over CCC and the stock was not easily marketable. The parties disagreed, however, on the extent of those discounts. The estate argued for a 25% discount for lack of control and an additional 35% discount for lack of marketability, while the Commissioner argued for discounts of 5% and 10% respectively. See App.. *infra*, 71a, 78a.

b. The Tax Court agreed with the Commissioner on the appropriate methodology for calculating the discount for the capital gains tax liability. App., *infra*, 55a-71a. The court noted that, under 26 C.F.R. 20.2031-1(b), "fair market value is determined by considering the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or to sell, and both having reasonable knowledge of the relevant facts." App., *infra*, 56a. The court further noted that "[t]he determination of the fair market value of property is a factual determination, and the trier of fact must weigh all relevant evidence of value." *Ibid.*

The Tax Court concluded that the relevant evidence did not support the estate's contention that the capital gains discount should be calculated based on an assumption that CCC would be liquidated immediately on Jelke's death. App., *infra*, 62a-71a. The court found that "[a] hypothetical buyer of CCC" would be "analogous to an investor/buyer of a mutual fund," "investing in a composite portfolio to profit from income derived from dividends and/or appreciation in value." *Id.* at 65a. Moreover, because the buyer would own only a 6.44% share in the business, and the other shareholders and CCC's managers did not intend to liquidate, the buyer "would be unable to liquidate the underlying securities." *Ibid.* Likewise, the court reasoned, "[a] hypothetical seller of CCC shares * * * would not accept a price that was reduced for possible tax on all built-in capital gain knowing that CCC sells or turns over only a small percentage of its portfolio annually." *Id.* at 65a-66a. The court therefore rejected the estate's proposed dollar-for-dollar discount. *Id.* at 70a.

Instead, the Tax Court agreed with the Commissioner that the capital gains tax liability should be discounted to present value, taking into account the approximately 6% historical turnover rate for CCC's assets. App., *infra*, 70a-71a. The asset turnover rate, the court concluded, "reasonably predicts the period over which the company's assets will be disposed of and thus built-in capital gains tax liability would likely be incurred." *Id.* at 71a. The court therefore found "it appropriate to use a 16-year period of recognition for the tax liability attributable to the built-in capital gain" and calculated a discounted total liability for capital gains tax of approximately $21 million. Using that discount, the court valued Jelke's CCC stock at $8,254,696. *Id.* at 71a, 83a.[2]

4. a. The court of appeals vacated and remanded. App., *infra*, 1a-47a. It instructed the Tax Court, on remand, to recalculate the value of Jelke's stock "using a dollar-for-dollar reduction of the entire $51 million built-in capital gains tax liability of CCC, under the arbitrary assumption that CCC is liquidated on the date of death and all assets sold." *Id.* at 3a.[3]

The court of appeals began by stating that "determination of fair market value is a mixed question of fact and law," and "determination of the appropriate valuation method is an issue of law that we review *de novo*." App., *infra*, 7a (citation omitted); see *id.* at 6a. Thus, the court reasoned, "[t]he question of whether the Tax

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[2] In reaching that valuation, the Tax Court applied additional discounts of 10% for lack of control and 15% for lack of marketability. See App., *infra*, 78a, 83a.

[3] The court of appeals summarily affirmed the discounts for lack of control and lack of marketability selected by the Tax Court. See App., *infra*, 3a n.4. Those discounts are no longer at issue in the case.

Court used the correct standard to determine fair market value is a legal issue." *Ibid.* (citing *Powers* v. *Commissioner*, 312 U.S. 259, 260 (1941)). The court stressed the importance of the standard of review to its decision, repeatedly noting that it was rejecting the Tax Court's valuation methodology under "*de novo* review" and "as a matter of law." *Id.* at 3a, 32a, 33a.

After surveying the case law on discounts for capital gains liability, the court of appeals chose to follow a categorical approach, which it believed the Fifth Circuit had adopted in *Dunn* v. *Commissioner*, 301 F.3d 339 (2002). See App., *infra*, 7a-33a. Under that approach, the court held, when valuing a corporation based on its net asset value, the Tax Court must always assume that a hypothetical buyer will immediately liquidate the corporation, triggering the entire accrued capital gains tax liability. *Id.* at 26a-33a; see *id.* at 22a-24a. According to the court of appeals, considerations of whether a hypothetical buyer actually could or would cause the liquidation of the company are "of no moment." *Id.* at 29a. Instead, the court stated, the Tax Court must "proceed under the arbitrary assumption that a liquidation takes place on the date of death" (*ibid.*) and apply a "dollar-for-dollar" discount equal to the entire capital gains tax liability that would have accrued if there had been an immediate liquidation of all of the corporation's assets (*id.* at 32a).

The court of appeals rejected the practice, followed by other courts, of "prophesying as to when the assets will be sold and reducing the tax liability to present value," reasoning that it "require[s] a crystal ball" and "hunt-and-peck forecasting." App., *infra*, 30a-31a. In contrast, the court of appeals stated, its categorical approach "provides certainty and finality," "has the virtue

of simplicity," and "prevents us, the federal judiciary, from assuming the role of arbitrary business consultants." *Id.* at 31a-33a. Accordingly, the court held, the "100% [discount] approach settles the issue as a matter of law." *Id.* at 32a.

b. Judge Carnes dissented. App., *infra*, 33a-47a. In his view, "[t]o avoid the effort, labor, and toil that is required for a more accurate calculation of the estate tax due, the majority simply assumes a result that we all know is wrong." *Id.* at 34a. Considering the historically low turnover of CCC's portfolio, CCC's substantial annual earnings, and the fact that CCC had no plans to liquidate its assets, Judge Carnes concluded that "the notion that the company would suddenly dispose of its highly profitable portfolio, ending the enviable earnings stream, and inflicting a substantial capital gains tax on its shareholders is preposterous." *Id.* at 38a-39a. Judge Carnes did not dispute that a willing buyer would pay less for CCC stock because of the built-in capital gains tax liability, but, he reasoned, "the buyer could not reasonably expect the seller to agree to a price that ignored completely the time value of money." *Ibid.* Judge Carnes therefore concluded that the "real value approach" adopted by the Tax Court, which discounted the capital gains tax liability based on a fact-based prediction about the rate at which CCC's assets were likely to be sold, yielded a "more accurate determination" of the actual value of Jelke's stock than the "simple but arbitrary" valuation method mandated by the majority. *Id.* at 37a-38a.

5. a. Shortly after the court of appeals issued its decision, this Court decided *CSX Transportation, Inc.* v. *Georgia State Board of Equalization*, 128 S. Ct. 467 (2007) (*CSX*). *CSX* involved a railroad's claim that its

state property tax assessment violated the Railroad Revitalization and Regulatory Reform Act of 1976 (4-R Act), which bars States from "'[a]ssess[ing] rail transportation property at a higher ratio to the [property's] true market value . . . than the ratio' between the assessed and true market values of other commercial and industrial property in the same taxing jurisdiction." *Id.* at 470 (quoting 49 U.S.C. 11501(b)(1)). This Court reversed the Eleventh Circuit's holding that, in resolving the railroad's claim, the district court was required to accept the valuation methodology chosen by the State. *Id.* at 475. In reaching its decision, the Court held that the determination of the fair market value of property, including the choice of valuation methods, "is at bottom just 'an issue of fact,'" *id.* at 473 (quoting *Suitum* v. *Tahoe Reg'l Planning Agency*, 520 U.S. 725, 741 (1997)), and that prohibiting the district court from "look[ing] behind the state's choice of valuation methods * * * limit[s] district court factfinding" in a manner that is not authorized by the 4-R Act, *id.* at 472.

b. Contending that the court of appeals' decision cannot be reconciled with *CSX*, the Commissioner petitioned for rehearing en banc in this case. The court of appeals denied rehearing en banc. App., *infra*, 85a.

REASONS FOR GRANTING THE PETITION

The court of appeals made two related errors: First, it incorrectly held that it could decide *de novo*, as a matter of law, the appropriate methodology for determining the fair market value of property for federal estate tax purposes. Second, it incorrectly mandated a method for calculating fair market value that is based on an "arbitrary assumption" (App., *infra*, 3a), rather than on all relevant facts and circumstances.

The court of appeals' decision conflicts with *CSX Transportation, Inc.* v. *Georgia State Board of Equalization*, 128 S. Ct. 467 (2007). *CSX* held that determination of the fair market value of property, including selection of the appropriate valuation methodology, is generally a question of fact, which cannot be resolved accurately if there are arbitrary limitations on the evidence that the factfinder may consider. The court of appeals' decision also conflicts with governing Treasury Department regulations, which establish that selection of the appropriate methodology for valuing property for estate tax purposes, in particular, is a fact-based inquiry that must taken into account "[a]ll relevant facts." 26 C.F.R. 20-2031-1(b). In addition, the decision below deepens an existing conflict among the courts of appeals on whether choice of valuation methodology for estate tax purposes is a question of fact or a question of law, and the questions presented by the decision are important ones.

For those reasons, the court of appeals' decision warrants further review. Plenary review by this Court may be premature at this time, however, because neither the court below nor any court of appeals has addressed how *CSX* bears on whether the choice of valuation methodology is a legal or factual question. Therefore, the most appropriate course is for this Court to vacate the decision of the court of appeals and remand for reconsideration in light of *CSX*. In the alternative, the petition for a writ of certiorari should be granted and the case set for briefing and oral argument.

A. The Decision Of The Court Of Appeals Conflicts With *CSX* And Governing Treasury Department Regulations

1. Less than a month after the court of appeals decided this case, this Court handed down its decision in *CSX*. *CSX* involved a suit by a railroad under the 4-R Act, which bars States from "'[a]ssess[ing] rail transportation property at a higher ratio to the [property's] true market value . . . than the ratio' between the assessed and true market values of other commercial and industrial property in the same taxing jurisdiction." *CSX*, 128 S. Ct. at 470 (quoting 49 U.S.C. 11501(b)(1)). In arguing that the State had "grossly overestimated the market value" of its property while accurately valuing other commercial and industrial property, the railroad contended that "the state appraiser's valuation methodologies were flawed, and urged the District Court to accept the market value estimated by its expert as more accurate." *Id.* at 471. The district court refused to do so because it concluded that the 4-R Act "'does not generally allow a railroad to challenge the state's chosen methodology,' as long as the State's methods are rational and not motivated by discriminatory intent." *Ibid.* (quoting *CSX Transp., Inc.* v. *Georgia State Bd. of Equalization*, 448 F. Supp. 2d 1330, 1341 (N.D. Ga. 2005)).

The Eleventh Circuit affirmed, agreeing with the district court that "railroads may not challenge state valuation methodologies under" the 4-R Act. *CSX Transp., Inc.* v. *Georgia State Bd. of Equalization*, 472 F.3d 1281, 1289 (2006). As it did in this case, the Eleventh Circuit viewed selection of the appropriate valuation methodology as a legal question, distinct from the ultimate factual question of actual value. See *id.* at 1291 ("valuation methodology" encompasses "all nonfactual

determinations involved in constructing a valuation process"). And the court of appeals concluded that the 4-R Act "restricts the railroads to challenging factual determinations." *Ibid.*

This Court reversed. In reaching its decision, the Court rejected the proposed "distinction between valuation methodologies and their application," concluding that such a distinction "is untenable given the way market value is calculated." *CSX*, 128 S. Ct. at 472. "Valuation," the Court explained, "is not a matter of mathematics," but "an applied science, even a craft," and valuations are generally "based on careful scrutiny of all the data available." *Ibid.* "Given the extent to which the chosen methods can affect the determination of value," the Court reasoned, a district court could not accurately determine true market value if it was "prevent[ed] from scrutinizing state valuation methodologies." *Id.* at 473; see *id.* at 474-475.

The Court also made clear that "[v]aluation of property," including the choice of valuation methodology, "is at bottom just 'an issue of fact.'" 128 S. Ct. at 473 (citation omitted). Prohibiting the district court from "look[ing] behind the state's choice of valuation methods," the Court ruled, "limit[s] district court factfinding" in a manner that is not authorized by the 4-R Act. *Id.* at 472. Indeed, that kind of "limitation on the types of evidence courts may consider as part of their factual inquiry" could not be squared with the 4-R Act's command that courts determine true market value. *Id.* at 473; see *id.* at 474-475.

CSX thus established two related propositions that are critical to the correct resolution of this case. First, determination of the fair market value of property, including selection of the appropriate valuation methodol-

ogy, is generally a question of fact, not a legal issue. And, second, to make an accurate determination, the factfinder must be free to scrutinize all available data, without being subject to arbitrary limitations on the evidence that it may consider.[4]

2. Congress may, of course, prescribe by statute that a particular methodology shall be used to determine the value of property under specified circumstances. For example, 26 U.S.C. 7520 directs taxpayers to use actuarial tables prescribed by the Secretary of the Treasury to value annuities, limited temporal interests in property, and remainders or reversionary interests in property. Similarly, 26 U.S.C. 2032A(e)(7) prescribes a method for valuing farmland for estate tax purposes. And 26 U.S.C. 2702 prescribes rules for valuing certain interests in trusts retained by the grantor.

A federal agency may also issue regulations prescribing the methodology for valuing a particular asset if Congress has expressly or impliedly granted the agency that authority. For example, Congress has ex-

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[4] *CSX* is consistent with earlier decisions of this Court that also suggest that determination of the fair market value of property (including selection of the appropriate valuation method) is generally a question of fact. See, *e.g.*, *Suitum* v. *Tahoe Reg'l Planning Agency*, 520 U.S. 725, 741 (1997) (stating that determining the value of transferable development rights as part of a takings challenge is "simply an issue of fact about possible market prices"); *SEC* v. *Central-Ill. Sec. Corp.*, 338 U.S. 96, 146-147 n.44 (1949) (rejecting a challenge to the method chosen by the SEC for valuing securities and noting that "this is predominately a question of fact, and the Commission's determination, supported as it was by substantial evidence, should not have been disturbed"); *Ex parte Williams*, 277 U.S. 267, 271 (1928) (holding that "the function to be performed" by a state board that assesses the value of property "remains simply that of fact-finding," "[w]hatever the scope of jurisdiction of the assessing body and whatever the method of valuation pursued").

pressly authorized the Secretary of the Treasury to "prescribe all needful rules and regulations" for the enforcement of the tax laws. 26 U.S.C. 7805(a). Based on that authority, or more specific statutory authorizations, the Secretary has promulgated a variety of regulations prescribing valuation methodologies for tax purposes for certain types of property. See, *e.g.*, 26 C.F.R. 20.2031-2(b)(1) (stock listed on an exchange); 26 C.F.R. 20.2031-8(a) (life insurance and annuity contracts); 26 C.F.R. 20.2031-8(b) (mutual fund shares); 26 C.F.R. 20.7520-3(b) (specifying situations where the actuarial tables for valuing annuities, etc., do not apply).

When a statute or regulation prescribes a specific methodology for calculating the value of property, courts must use that methodology. But no statute or regulation prescribes a special rule for valuing, for estate tax purposes, stocks in closely held corporations like CCC, for which no relevant market prices are available. The statutory provisions addressing calculation of the estate tax provide that the decedent's gross estate includes the "value" of all property of any kind, wherever located, to the extent of the decedent's interest in the property. 26 U.S.C. 2031(a), 2033. And Treasury Department regulations implementing those statutes confirm that the ordinary, default rule applies—valuation of stock in a closely-held corporation is a question of fact that must be resolved based on all the relevant circumstances of the particular case.

The Treasury regulations provide that, as a general matter, the "value" of property includible in an estate "is its fair market value at the time of the decedent's death," defined as "the price at which the property would change hands between a willing buyer and a willing seller." 26 C.F.R. 20.2031-1(b). The regulations

expressly state that "[a]ll relevant facts and elements of value as of the applicable valuation date shall be considered in every case." *Ibid.*

The regulation that specifically addresses valuing stocks for which market prices are not available confirms that no specific valuation methodology applies as a matter of law; instead, the appropriate valuation methodology is a factual determination that depends on the particular circumstances of each case. See 26 C.F.R. 20.2031-2(f) ("[T]he weight to be accorded * * * evidentiary factors considered in the determination of a value depends upon the facts of each case."). The Revenue Ruling that explicates that regulation likewise stresses that "[n]o general formula may be given" for determining fair market value, and "all relevant factors affecting the fair market value must be considered." Rev. Rul. 59-60, 1959-1 C.B. at 237.

3. The decision of the court of appeals cannot be squared with *CSX* and the governing Treasury regulations. As described above, *CSX* and the regulations establish that determination of the value of property for estate tax purposes, including selection of the appropriate valuation methodology, is a question of fact. Accordingly, the court of appeals should have reviewed the Tax Court's choice of valuation methodology under the deferential clear-error standard. See, *e.g.*, *Anderson* v. *City of Bessemer City*, 470 U.S. 564, 573 (1985); Fed. R. Civ. P. 52(a)(6). The court of appeals, however, held that "determination of the appropriate valuation method is an issue of law," and it therefore applied *de novo* review. App., *infra*, 7a (quoting *Dunn* v. *Commissioner*, 301 F.3d 339, 348 (5th Cir. 2002)).

In addition, *CSX* and the governing regulations make clear that, when determining fair market value, the

factfinder must consider all the relevant facts and circumstances in each particular case. In direct conflict with that principle, the court of appeals established a one-size-fits-all rule that precludes consideration of the relevant facts and circumstances. The court held that, whenever the Tax Court values stock in a company based on its net assets, the court must always apply a dollar-for-dollar discount for the entire capital gains tax that the company would have incurred if the company had been liquidated on the valuation date. App., *infra*, 26a-33a. Factual circumstances indicating that liquidation would not or could not have occurred on that date, the court of appeals held, are "of no moment." *Id.* at 29a. Instead, the Tax Court must "proceed under the arbitrary assumption that a liquidation takes place" on that date. *Ibid.* The court of appeals thus prohibited the Tax Court in this case from considering numerous facts that established that CCC's assets would not be liquidated on Jelke's death but were likely instead to be sold over a 16-year period: the assets had historically turned over at a rate of less than 6% a year; CCC's management and controlling shareholders had no plans to liquidate; a purchaser of Jelke's small minority interest in CCC could not have forced a liquidation; and Jelke's interest in CCC was attractive as an ongoing investment. The court of appeals' prohibition against consideration of those highly relevant facts cannot be reconciled with *CSX* or the governing regulations.[5]

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[5] Despite its holding that the Tax Court had to value CCC based on an assumption that its assets would be immediately liquidated, the court of appeals affirmed the Tax Court's determination that Jelke's stock should be discounted to reflect its lack of marketability and his lack of control. App., *infra*, 3a n.4. Those discounts would make sense only if the valuation were based on a hypothetical sale to a third party

The court of appeals apparently believed that this Court's decision in *Powers* v. *Commissioner*, 312 U.S. 259 (1941), established that selection of the appropriate methodology for valuing property for tax purposes is a question of law. See App., *infra*, 6a (citing *Powers*). The court of appeals misread *Powers*.

Powers was one of several cases involving interpretation of Section 506 of the Revenue Act of 1932, 47 Stat. 248, which provided that "for gift-tax purposes the amount of a gift of property shall be 'the value thereof at the date of the gift.'" *Guggenheim* v. *Rasquin*, 312 U.S. 254, 255 (1941) (quoting Section 506). In *Guggenheim*, which was the lead case, the Court held that "value" means the "value to the owner of the entire bundle of rights" in the property, and therefore "[a]ll of the economic benefits of [the property] must be taken into consideration in determining its value for gift-tax purposes." *Id.* at 257-258. Based on that "interpretation of the meaning of 'value' in § 506," the Court held that the cash surrender value of a single-premium life insurance policy does not accurately measure the policy's value for gift-tax purposes. *Id.* at 258. The Court explained that a policy's cash surrender value understates its true value because "[s]urrender of a policy represents only one of the rights of the insured or beneficiary," which also include the rights to retain the policy as an investment and to collect the proceeds on the death of the insured. *Id.* at 257.

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who would continue to own stock in an ongoing company. They make no sense if one assumes (as the court of appeals commanded) that the hypothetical purchaser would receive the liquidation value of his shares. Thus, the court of appeals' opinion not only conflicts with *CSX* and the governing regulations, but it is also internally inconsistent.

Powers involved the same issue as *Guggenheim*. The Board of Tax Appeals had ruled that various single-premium life insurance policies transferred by Powers should be valued for gift tax purposes based on their cash surrender value, and the court of appeals had reversed. Although the court of appeals' decision accorded with *Guggenheim*, Powers contended that this Court should nonetheless reverse the court of appeals. Powers argued that the court of appeals had erred in reversing the Board because the court was authorized to reverse only if the Board's decision was "not in accordance with law." *Powers*, 312 U.S. at 260 (quoting Internal Revenue Code of 1939, § 1141(c)(1), 53 Stat. 164). This Court rejected that argument, holding that "the question of what criterion should be employed for determining the 'value' of the gifts is a question of law." *Powers*, 312 U.S. at 259. That holding indicates only that this Court's interpretation in *Guggenheim* of the statutory term "value" resolved a question of law by holding that the entire bundle of rights, not solely cash surrender value, must be considered, and that the Board therefore had committed legal error by using a valuation methodology that was inconsistent with the gift tax statute. *Powers* does not suggest that the choice among valuation methods that are *consistent* with the underlying statute is a question of law. As both *CSX* and the governing Treasury regulations make clear, that choice is a question of fact, and the court of appeals erred in ruling otherwise.

B. The Decision Of The Court Of Appeals Conflicts With Decisions Of Other Courts Of Appeals

1. The decision of the court of appeals is not only erroneous but deepens an existing conflict among the courts of appeals on whether the choice of valuation methodology is an issue of fact or law. In addition to the court below, the Third and the Fifth Circuits have held that selection of a valuation methodology is a legal issue that is reviewed *de novo*. See *Amerada Hess Corp.* v. *Commissioner*, 517 F.2d 75, 82, 84 (3d Cir.) (Tax Court committed legal error in using "barter-equation method" to determine fair market value of stock), cert. denied, 423 U.S. 1037 (1975); *Dunn*, 301 F.3d at 348 (choice of methodology for valuing discount for capital gains tax liability is legal question subject to *de novo* review).

In contrast, the Fourth, Sixth, and Ninth Circuits have held that selection of a valuation methodology is a factual issue that is reviewed for clear error. See *Estate of Godley* v. *Commissioner*, 286 F.3d 210, 214 (4th Cir. 2002) (whether a taxpayer is entitled to a discount for lack of control is question of fact reviewed for clear error); *Gross* v. *Commissioner*, 272 F.3d 333, 343 (6th Cir. 2001) (choice of appropriate valuation methodology for particular stock is question of fact), cert. denied, 537 U.S. 827 (2002); *Sammons* v. *Commissioner*, 838 F.2d 330, 334 (9th Cir. 1988) (whether Tax Court appropriately selected cost method of valuing art collection was question of fact reviewed for clear error).

The Seventh and Tenth Circuits, although they have not squarely addressed the issue, have both applied the clear-error standard when reviewing the Tax Court's selection of a valuation method. See *Van Zelst* v. *Commissioner*, 100 F.3d 1259, 1261-1263 (7th Cir. 1996) (upholding Tax Court's choice of comparable-sales method,

rather than capitalization-of-income method, under clear-error review), cert. denied, 522 U.S. 807 (1997); *Estate of Holl* v. *Commissioner*, 54 F.3d 648, 650 (10th Cir. 1995) (reversing Tax Court's choice of valuation method under clear-error review); see also *Heyen* v. *United States*, 945 F.2d 359, 364 (10th Cir. 1991) (noting that "valuation of stock is a question of fact" and upholding jury's valuation after noting that jury had rejected government's proposed valuation method and instead valued stock based on its book value).

The position of several other courts of appeals appears to be somewhat internally inconsistent. The First Circuit has held that whether the Tax Court used the "proper criterion" to arrive "at its determination of value" is a question of law. See *Collins* v. *Commissioner*, 216 F.2d 519, 522 (1954). In at least one other case, however, the First Circuit has treated the Tax Court's choice between two valuation methodologies as a factual question that is reviewed for clear error. See *McMurray* v. *Commissioner*, 985 F.2d 36, 40-41 (1993). The Second Circuit also has held that choice of valuation methodology is a question of law. See *Saltzman* v. *Commissioner*, 131 F.3d 87, 93 (1997). But, on at least one other occasion, it has reviewed the Tax Court's selection of a valuation method under a substantial evidence standard. See *Silverman* v. *Commissioner*, 538 F.2d 927, 933 (1976).

The Eighth Circuit also has stated that the "question of what criteria should be employed for determining value is one of law," but it declined to treat the question in that case "as one purely of law," and it noted that "the weight to be given each of the many valuation factors depends upon the facts of each case." *Palmer* v. *Commissioner*, 523 F.2d 1308, 1310-1311 (1975). In a more

recent case, the Eighth Circuit upheld a jury finding on the fair market value of stock and debentures, stating that a "reasonable jury" could have "disregard[ed] the liquidation value method" proposed by the government "when determining the fair market value of" the stock. *Becker* v. *United States*, 968 F.2d 691, 694 (1992). The Federal Circuit likewise has held that selection of the criteria by which the court determines the value of property for tax purposes is a legal issue that is reviewed *de novo*, *Krapf* v. *United States*, 977 F.2d 1454, 1458-1460 (1992), but, in the same case, it stated that the trial court "has discretion in choosing a method of evaluation," *id.* at 1463.[6]

2. There is also tension among the courts of appeals on the narrower issue of how the Tax Court should calculate a discount for built-in capital gains tax liability when it is valuing a company that holds appreciated assets. The court below held that the Tax Court must always apply a dollar-for-dollar discount based on the capital gains tax that the company would have incurred if it had been liquidated on the valuation date, at least if the court is valuing the company based on its net assets. See App., *infra*, 26a-33a. The Fifth Circuit also has stated that a dollar-for-dollar discount based on an assumption of immediate liquidation is appropriate, at least in some circumstances. See *Dunn*, 301 F.3d at 352-353.[7]

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[6] The District of Columbia Circuit has not addressed the issue. That court has stated, however, that "there is no definite formula by which to determine fair market value" for tax purposes, and the question is "one of fact to be determined by the evidence." *Crawford* v. *Helvering*, 70 F.2d 744, 745 (1934) (per curiam).

[7] As the Tax Court noted, the facts of *Dunn* differed from those in this case in material respects. App., *infra*, 66a-67a. Most significantly,

Two other courts of appeals, in contrast, have suggested that a dollar-for-dollar discount is inappropriate, at least in some circumstances. In *Eisenberg* v. *Commissioner*, 155 F.3d 50 (1998), the Second Circuit held that the Tax Court had erred in failing to include a discount for potential capital gains tax liability when it calculated the value of property included in the decedent's estate. The court of appeals remanded for a recalculation but stated that it "would not be a correct conclusion" that "the full amount of the potential capital gains tax should be subtracted from what would otherwise be the fair market value" of the property. *Id.* at 58-59 & n.15. Similarly, the Sixth Circuit, in an unpublished opinion that remanded an estate tax case for the Tax Court to consider evidence on the appropriate discount, noted that taxpayers "may not be able to deduct the full of amount" of potential capital gains tax liability. *Estate of Welch* v. *Commissioner*, No. 98-2007, 2000 WL 263309, at *5-*6 (Mar. 1, 2000) (208 F.3d 213 (Table)).

C. The Questions Presented Are Important And Should Be Reconsidered By The Court Of Appeals In Light Of *CSX*

The issues presented by the decision below are important. The issue whether the choice of a valuation method presents a factual question or a legal one can arise in any tax case in which the parties dispute the value of property. And, as the above discussion of the

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the Fifth Circuit in *Dunn* was valuing a majority interest in a corporation, while Jelke's interest in CCC was a small minority interest. *Ibid.* "In that regard," the Tax Court explained, the Fifth Circuit "tempered its holding in *Estate of Dunn* by explaining that if it were valuing a minority ownership interest, a business-as-usual assumption or earnings-based approach may be more appropriate." *Id.* at 67a (citing *Dunn*, 301 F.3d at 353 n.25).

disagreement among the courts of appeals indicates, the issue has in fact arisen in numerous cases.

How that issue is resolved has important practical implications. Treating the choice of a valuation methodology as a question of law impairs the accuracy of property valuations because, as this Court recognized in *CSX*, the factfinder cannot accurately determine the true market value of property unless it is free to make that determination in light of all the relevant facts and circumstances. See *CSX*, 128 S. Ct. at 473, 474-475. Treating the choice of a valuation methodology as a question of law also imposes unjustified burdens on both litigants and the courts. As this Court explained in *Anderson*, "[t]he trial judge's major role is the determination of fact, and with experience in fulfilling that role comes expertise. Duplication of the trial judge's efforts in the court of appeals would" at best "contribute only negligibly" to an accurate determination of value and do so "at a huge cost in diversion of judicial resources." 470 U.S. at 574-575. It would also require an increased commitment of resources from the parties, who "have already been forced to concentrate their energies and resources on persuading the trial judge" that their respective valuation methodologies are correct. *Id.* at 575.

The specific question of how to calculate the appropriate discount for capital gains tax liability when valuing a company with appreciated assets is also important in its own right. The rule adopted by the court of appeals would be likely to result in a significant loss of tax revenue for the government. The court's rule would, in numerous cases, give taxpayers the windfall of a dollar-for-dollar discount on the taxable value of the their property based on an immediate capital gains tax that they almost certainly would not incur. The consequent

loss in tax revenue would likely be substantial because there has been a tremendous amount of appreciation in the value of assets over the last thirty years. For example, between December 31, 1977, and December 31, 2007, the Standard & Poor's 500 Index appreciated approximately 1444% and the Dow Jones Industrial Index appreciated more than 1495%. See *S&P 500 Index* <http://money.cnn.com/quote/historical/historical.html?symb=SPX> (visited June 18, 2008); *Dow Jones Industrial Average* <http://money.cnn.com/quote/historical/historical.html?symb=INDU> (visited June 18, 2008).

Because of the importance of the issues, and the conflict between the decision below and this Court's precedent, governing regulations, and decisions of other courts of appeals, the decision below warrants further review. Nonetheless, the court of appeals has not yet addressed the consequences of this Court's decision in *CSX* for the rule that it has adopted. Other courts of appeals also have not had the opportunity to reconsider their approach in light of *CSX*. For that reason, the government believes that plenary review by this Court may be premature at this time. Instead, in the government's view, the most appropriate course is for the Court to vacate the decision of the court of appeals and remand for reconsideration in light of *CSX*. If, however, the Court believes that the issues are sufficiently developed to warrant full review by the Court at this time, the Court should instead grant the petition and set the case for argument.

CONCLUSION

The petition for a writ of certiorari should be granted, the judgment of the court of appeals should be vacated, and the case should be remanded for further consideration in light of *CSX Transportation, Inc.* v.

Georgia State Board of Equalization, 128 S. Ct. 467 (2007). In the alternative, the petition should be granted and the case set for briefing and oral argument.

Respectfully submitted.

GREGORY G. GARRE
Acting Solicitor General
NATHAN J. HOCHMAN
Assistant Attorney General
EDWIN S. KNEEDLER
Deputy Solicitor General
MATTHEW D. ROBERTS
Assistant to the Solicitor General
JONATHAN S. COHEN
RANDOLPH L. HUTTER
Attorneys

JUNE 2008

APPENDIX A

UNITED STATES COURT OF APPEALS
FOR THE ELEVENTH CIRCUIT

No. 05-15549

ESTATE OF FRAZIER JELKE, III, DECEASED,
WACHOVIA BANK, N.A., F.K.A. FIRST UNION
NATIONAL BANK, PERSONAL REPRESENTATIVE,
PETITIONER-APPELLANTS

v.

COMMISSIONER OF INTERNAL REVENUE,
RESPONDENTS-APPELLEE

Date: Nov. 15, 2007

Before: TJOFLAT, CARNES and HILL, Circuit Judges.

HILL, Circuit Judge:

This estate tax case presents on appeal an issue of first impression in this circuit.[1] It involves the proper valuation for estate tax purposes of a 6.44% stock interest, or 3,000 shares, owned by the decedent, Frazier Jelke III (Jelke or decedent or estate),[2] in a closely-held, investment holding company, Commercial Chemi-

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[1] The issue has been previously addressed by the Second Circuit in 1998, the Sixth Circuit in 2000, and the Fifth Circuit in 2001 and 2002. *See* IV.C.2 & 3, *infra*.

[2] The 3,000 shares were held in a revocable trust of which Jelke was the primary beneficiary. The revocable trust terminated at Jelke's death, and its assets were distributed to his issue.

cal Company (CCC), owning appreciated, marketable securities.[3]

The issue is whether or not the Tax Court used the appropriate valuation methodology in computing the net asset value of CCC to determine the value of Jelke's interest in CCC for estate tax purposes on the date of death. The Tax Court, adopting the Commissioner's expert witness appraiser's approach, allowed the estate only a partial $21 million discount for CCC's built-in capital gains tax liability, indexed to reflect present value on the date of Jelke's death, using projections based upon the court's findings as to when the assets would likely be sold and when the tax liability would likely be incurred, i.e., in this case, over a sixteen-year period. Using what could be termed an economic market reality theory, the estate argued, under the rationale set forth by the Fifth Circuit Court of Appeals in *Estate of Dunn v. Comm'r*, 301 F.3d 339 (5th Cir. 2002), that a 100% dollar-for-dollar discount was mandated for CCC's entire contingent $51 million capital gains tax liability. Under this theory, it is assumed that CCC is liquidated on the date of Jelke's death, the valuation date, and all assets of CCC are sold, regardless of the parties' intent to liquidate or not, or restrictions on CCC's liquidation in general.

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[3] At all times, CCC was a C corporation for tax purposes. From 1922 to 1974, CCC was a successfully operating chemical manufacturing business, producing chemicals such as arsenic acid and calcium arsenate. In 1974, CCC sold its manufacturing assets to an unrelated third party, yet maintained its name, CCC, as a holding company investing the sales proceeds. At the date of Jelke's death, CCC's stock portfolio was comprised of 92% blue-chip domestic equities and 8% international equities, the market values of which were readily and easily available.

Based upon the following historical overview, discussion, and precedential authority, we are in accord with the simple yet logical analysis of the tax discount valuation issue set forth by the Fifth Circuit in *Estate of Dunn*, 301 F.3d at 350-55, providing practical certainty to tax practitioners, appraisers and financial planners alike. Under a *de novo* review, as a matter of law, we vacate the judgment of the Tax Court and remand with instructions that it recalculate the net asset value of CCC on the date of Jelke's death, and his 6.44% interest therein, using a dollar-for-dollar reduction of the entire $51 million built-in capital gains tax liability of CCC, under the arbitrary assumption that CCC is liquidated on the date of death and all assets sold.[4]

I. FACTUAL BACKGROUND[5]

Jelke died testate on March 4, 1999, in Miami, Florida. On the date of his death, CCC's marketable securities had a fair market value of $178 million, plus a built-in contingent capital gains tax liability of $51 million on those securities. Combined with $10 million in other CCC assets, without regard to the tax liability, CCC's net asset value totaled $188 million.[6]

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[4] Upon our thorough review of the record, we are satisfied that the Tax Court did not clearly err when it determined and discounted the value of Jelke's 6.44% interest in CCC for lack of control by 10%, and for lack of marketability by 15%. These two issues are affirmed without further discussion.

[5] Many of the facts were stipulated to by the parties and set forth in the Tax Court's findings of fact. *Estate of Jelke v. Comm'r*, 89 T.C.M. (CCH) 1397 (2005). Only facts pertinent to this appeal will be recited here.

[6] All parties agree that CCC is well managed by experienced individuals. Its board of directors is elected by CCC shareholders. Under CCC's articles of incorporation, shareholders are not allowed to partici-

On the estate's federal estate tax return filed December 6, 1999, Jelke's 6.44% interest in CCC, held through his revocable trust, was included in his gross estate under Section 2031 at a value of $4,588,155. I.R.C. § 2031. The estate calculated this figure by reducing CCC's $188 million net asset value by $51 million, or 100% of the built-in capital gains tax liability. It then applied a 20% discount for lack of control and a 35% discount for lack of marketability.

In his December 2, 2002, notice of deficiency issued to the estate, the Commissioner determined that Jelke's estate owed a deficiency in estate tax of $2,564,772, resulting from an undervaluation of Jelke's 6.44% interest in CCC.[7] The Commissioner determined that the value of Jelke's 6.44% interest in CCC was $9,111,000, not the $4,588,155, claimed by the estate. Unlike the estate's 100% discount, he calculated the $9,111,000 using a zero discount for built-in capital gains taxes, and what he described as "reasonable" discounts for lack of control and lack of marketability.

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pate in the operation or management of the investment holding company, nor do they show any interest to do so. CCC's primary investment goal is long-term capital stock growth. CCC had a relatively high annual rate of return, or 23%, for the five-year period [1994-1998] prior to death, lagging just behind the S & P 500's historical average for the same time period. CCC paid steady annual dividends. Its long-term investment goals produced a low asset annual turnover rate of 6%, and $51 million in unrealized capital gains. During the five years prior to death, there was no intent to liquidate CCC.

[7] The other CCC shareholders are irrevocable trusts, holding interests in CCC ranging from 6.18% to 23.668%, the beneficiaries of which are all related Jelke family members. From 1988 to the date of trial, there were no sales of CCC stock. There are no restrictions on the sale or transfer of CCC stock under the terms of any of the Jelke family trusts. One trust does not terminate before the year 2019.

II. PROCEDURAL BACKGROUND

The estate filed a petition in Tax Court in March 2003, contesting the Commissioner's $9,111,000 fair market value of Jelke's 6.44% interest in CCC stock on the date of death. It claimed that the Commissioner had based his value on an incorrect net asset value of CCC, by declining to discount CCC's net asset value of $188 million, by the $51 million in contingent built-in capital gains tax liability, accrued as of the date of death. The estate also claimed that the Commissioner undervalued the two additional discounts available to the estate, one for lack of marketability and one for lack of control.[8]

After a two-day bench trial, the Tax Court rejected the estate's position that CCC's net asset value must be reduced dollar-for-dollar by the entire amount of the built-in capital gains tax liability under *Estate of Dunn*, 301 F.3d at 351-53, as the *Estate of Dunn* was a Fifth Circuit, not an Eleventh Circuit, case. It determined that a discount was available, but not one for 100%.

The Tax Court noted that a hypothetical buyer of 6.44% of CCC stock single-handedly would be unable to cause or force a liquidation of CCC. It stated that CCC's long-term history of dividends and appreciation, with no immediate plans to liquidate (one trust continues until 2019), together with its low annual turnover of securities in the portfolio, belied the *Estate of Dunn*'s threshold, arbitrary assumption of complete liquidation on the valuation date. Further, the Tax Court distinguished *Estate of Dunn* on the fact that the Fifth Circuit in *Estate of Dunn* was valuing a majority, not a minority, shareholder interest as was present here. Also the

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[8] *See supra* note 4.

company valued in the *Estate of Dunn* was primarily (85%) an operating company, unlike CCC, a 100% investment holding company.

Under the net asset valuation approach, the Tax Court adopted the Commissioner's argument that the capital gains tax discount should be reduced to present value, as computed on an annualized, indexed basis, over the sixteen-year period it was expected to be incurred as the assets turned over.[9] Instead of a $51 million reduction, the Tax Court's present value application to net asset value resulted in a $21 million tax discount reduction, and a net deficiency in estate tax of $1 million.[10]

This appeal follows.

III. STANDARD OF REVIEW

The question of whether the Tax Court used the correct standard to determine fair market value is a legal issue. *See Powers v. Comm'r*, 312 U.S. 259, 260, 61 S. Ct. 509, 85 L. Ed. 817 (1941). We review *de novo* the Tax Court's rulings on the interpretation and application of the tax code. *See Estate of Blount v. Comm'r*, 428 F.3d 1338, 1342 (11th Cir. 2005) (citation omitted). The Tax Court's findings of fact are reviewed for clear error.

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[9] The estate attacks this approach on the basis that it is incomplete and inconsistent, as over this sixteen-year period, CCC's securities could appreciate in value, increasing tax payments and obviating the need to reduce built-in capital gains by present value principles. The same could be true if the assets were to depreciate in value over the projected period.

[10] In addition, the Tax Court applied a 10% discount for lack of control and a 15% discount for lack of marketability. As stated, *supra* note 4, we find no clear error in the Tax Court's analysis and calculation of the other two discounts available to the estate. These two issues need no further discussion.

Id. Where a question of fact, such as valuation, requires legal conclusions, we review those underlying legal conclusions *de novo*. *See Adams v. United States*, 218 F.3d 383, 386 (5th Cir. 2000). A determination of fair market value is a mixed question of fact and law: the factual premises are subject to a clearly erroneous standard while the legal conclusions are subject to *de novo* review. *See Estate of Dunn*, 301 F.3d at 348 (citations omitted). "The mathematical computation of fair market value is an issue of fact, but determination of the appropriate valuation method is an issue of law that we review *de novo*." *Id.*

IV. DISCUSSION

A. Introduction

The issue in this case is, for estate tax purposes, the proper calculation of the magnitude of the discount for built-in capital gains taxes in valuing stock in a closely-held corporation on the date of death. A general overview of the applicable tax statutes, regulations and revenue rulings is appropriate.

1. The Tax Code and Treasury Regulations

Section 2031(a) provides that the value of a decedent's gross estate shall be determined by including the value at the time of death of all property, real or personal, tangible or intangible, wherever situated. I.R.C. § 2031(a). Section 20.2031-1(b) provides that the value of every item of property includable in a decedent's gross estate . . . is its fair market value at the time of the decedent's death. Treas. Reg. § 20.2031-1(b). The fair market value is the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or

to sell and both having reasonable knowledge of relevant facts.[11] *Id.* All relevant facts and elements of value as of the applicable valuation date shall be considered. *Id.*

2. Internal Revenue Service Guidelines

Revenue Ruling 59-60 provides the foundation for undertaking an analysis of a closely-held stock's value. *Rev. Rul.* 59-60, 1959-1 C.B. 237.[12] Although it has been modified and amplified over the years, Revenue Ruling 59-60 still remains the focal point for the proper method of valuing closely-held securities.[13]

Closely-held corporations, are, by definition, corporations of which the shares are owned by a relatively limited number of shareholders. *Id.* at § 2.03. Their shares are traded little, if any, in the marketplace so there are usually no asked prices or third-party sales that would represent an ascertainable basis for determining the fair market value of the stock under the rules generally applicable to publicly traded stock. *Id.*

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[11] The buyer and seller are hypothetical, not actual persons, and each is a rational economic actor; that is, each seeks to maximize his advantage in the context of the market that exists on the valuation date. *See Estate of Newhouse v. Comm'r*, 94 T.C. 193, 218, 1990 WL 17251 (1990).

[12] While Revenue Ruling 59-60 sets forth the basic approach for valuing closely-held securities, it recognizes that there is no one correct method. Rev. Rul. 59-60, 1959-1 C.B. 237. All of the facts and circumstances of each individual case must be analyzed by the appraiser who is expected to use common sense and informed judgment and maintain "a reasonable attitude in recognition of the fact that valuation is not an exact science." *Id.* at § 3.01.

[13] *Rev. Rul.* 59-60, 1959-1 C.B. 237, *modified by Rev. Rul.* 65-193, 1965-2 C.B. 370, *amplified by Rev. Rul.* 77-287, 1977-2 C.B. 319, *amplified by* Rev. Rul. 80-214, 1980-2 C.B. 101, *amplified by* Rev. Rul. 83-120, 1983-2 C.B. 170.

The fair market value of closely-held securities also clearly depends upon the potential buying public's estimate of the worth of the securities. *Id.* at § 3.02. The level of risk that a buyer will be willing to accept in purchasing stock of a closely-held company will directly impact the value of that stock. *Id.*

Revenue Ruling 59-60 states that "[t]he value of the stock of a closely-held investment or real estate holding company, whether or not family owned, is closely related to the value of the assets underlying the stock." *Id.* at § 5(b). The net asset value method of valuation, which assumes that the value of the corporation is based upon the fair market value of its underlying assets, is in turn determined by applying the venerable willing buyer-willing seller test. *Id.* The net asset value method is the best method to use in valuing corporations that are essentially holding companies, while an earnings-based method applies to operating companies. *Id.*[14]

B. Historical Overview of the Issue Presented on Appeal

1. The Law Prior to the Tax Reform Act of 1986

In *General Utilities & Operating Co. v. Helvering*, 296 U.S. 200, 56 S. Ct. 185, 80 L. Ed. 154 (1935), the Supreme Court held that a C corporation did not recognize taxable income at the corporate level on a distribution of appreciated property to its shareholders. *Id.* at 206, 56

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[14] The Tax Court agrees. *See, e.g., Estate of Smith v. Comm'r*, 78 T.C.M. (CCH) 745, 1999 WL 1001184, (1999) (where the net asset valuation approach given greatest weight in valuing corporation engaged in farming operation, as the underlying value of the real property is the greatest contributor to the corporation's worth); *Estate of Ford v. Comm'r*, 66 T.C.M. (CCH) 1507 (1993), *aff'd*, 53 F.3d 924 (8th Cir.1995); *Estate of Andrews v. Comm'r*, 79 T.C. 938, 1982 WL 11197 (1982).

S. Ct. 185. Congress responded to this holding, later to become known as "the *General Utilities* doctrine," by enacting Section § 311(a).[15] From 1935 to 1986, the fair market value of the distributed corporate property became the shareholders' adjusted stepped-up basis in the property received. It was therefore possible for a corporation to distribute its appreciated assets to its shareholders without incurring any income tax liability at the corporate level. *Id.*; *see also* I.R.C. § 301(d).

With one exception during this fifty-one year period, case law did not allow a discount for built-in capital gains tax liability when a sale or liquidation was neither planned nor imminent, as it was deemed by the courts to be too uncertain, remote or speculative.[16] *See Estate of Andrews v. Comm'r*, 79 T.C. 938, 942, 1982 WL 11197 (1982) (projected capital gains taxes do not reduce the value of closely-held stock when liquidation is only speculative as it is unlikely taxes will ever be incurred); *Estate of Piper v. Comm'r*, 72 T.C. 1062, 1086-87, 1979 WL 3788 (1979) (in gift tax case, capital gains discount unwarranted under net asset value method where there is no evidence that a liquidation of the investment companies was planned); *Estate of Cruikshank v. Comm'r*, 9 T.C. 162, 165, 1947 WL 28 (1947) (no sale of portfolio

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[15] This new tax code statute provided in part: "[N]o gain or loss shall be recognized to a corporation on the distribution (not in complete liquidation) with respect to . . . (1) its stock (or rights to acquire its stock), or (2) property." I.R.C. § 311(a).

[16] The exception was *Obermer v. United States*, 238 F. Supp. 29 (D. Haw. 1964), where a capital gains discount was permitted when the taxpayer established that the assets were required to be sold by the corporation to meet the terms of a restrictive agreement. Therefore, liquidation was proved by the taxpayer to be imminent and not speculative. *Id.* at 35-36.

securities projected in closely-held family investment corporation).

The pre-1986 cases do not announce a rule of law that such taxes may never affect the value of stock, but that taxes will create an impact only when the taxpayers can prove that the assets will in fact be sold in the foreseeable short-term future, rather than held for long-term investment return. *See Obermer v. United States,* 238 F. Supp. 29, 35-36 (D.Haw. 1964). The pre-1986 cases are now, however superceded by statute. *See* Tax Reform Act of 1986, *Pub. L. No. 99-514,* § 631, 100 Stat. 2085.

2. The Tax Reform Act of 1986

The Tax Reform Act of 1986 (TRA 1986) made dramatic tax law changes. New rules were enacted to require the recognition of corporate-level gains on the distributions of appreciated property under Section § 311(b), thereby repealing the *General Utilities* doctrine and I.R.C. §§ 336 and 337. *See* I.R.C. § 311(b).

Prior to the repeal of the *General Utilities* doctrine by TRA 1986, no corporate tax would have been required to be paid and no discount would have been allowed. TRA 1986 required recognition of corporate-level gains and losses on liquidating sales and on distributions of corporate property.

With the repeal of the doctrine, courts began to recognize the possibility that a discount related to the capital gains taxes incurred should be allowable. Due to the taxpayer's inability to receive a step-up in basis to fair market value on the valuation date after TRA 1986, it now became more important than ever for a taxpayer to be able to quantify his or her loss in value of the stock

due to inherent capital gains tax liability in the corporation.[17]

3. Post-TRA 1986 until *Estate of Davis* in 1998

Although subject to the 1986 legislation, as late as 1991, the Commissioner continued to adhere to his pre-1986 position that no capital gains discount was permitted on distributions of closely-held corporate stock, ignoring the fact that a corporate-level income tax now would be incurred upon its liquidation. *See I.R.S. Tech. Adv. Mem.* 91-50-001 (1991) (the Commissioner will continue to adhere to his historical rule against allowing a capital gains tax discount).[18] During this twelve-year period, the Commissioner, while agreeing that a capital gains discount is allowable in theory, and as a matter of law, uniformly denied the discount unless the taxpayer could prove that payment was imminent. *See Estate of Gray v. Comm'r*, 73 T.C.M. (CCH) 1940, *9 (1997) (no capital gains tax discount for stock in corporation that held installment note because payment of the note de-

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[17] At a decedent's death, appreciated property included in the decedent's gross estate generally receives a Section 1014 "step-up" in basis so that the fair market value of the property is equal to its basis. I.R.C. § 1014. However, if the decedent's property is stock in a corporation and that corporation owns appreciated capital gains property, then, as a result of the repeal of the *General Utilities* doctrine, the corporation would have to pay tax on such gain on its liquidation, reducing the value of the corporation. *See* Bittker & Eustice, *Federal Income Taxation of Corporations and Shareholders* ¶¶ 8.20, 8.21 (Warren, Gorham & Lamont, 7th ed. 2000).

[18] *See also* AOD 1999-001 (Jan. 29, 1999) (the Commissioner will take potential capital gains taxes into account when determining the appropriate discounts for a C corporation, but the amount of the discount and the cases in which it will be allowed will be determined on a case-by-case basis).

pended upon sale of land by the maker, making the risk of capital gains too speculative to be a factor in valuation).

From 1986 to 1998, taxpayers were unsuccessful in their arguments that the repeal of the *General Utilities* doctrine made it difficult to avoid capital gains at the corporate level, and that, therefore, *ipso facto* a discount for built-in capital gains should be allowed. *See Estate of Bennett v. Comm'r*, 65 T.C.M. (CCH) 1816, *12 (1993); *Estate of Ward v. Comm'r*, 87 T.C. 78, 104, 1986 WL 22156 (1986) (no discount as there was no evidence that liquidation is imminent or even contemplated). The courts continued to adhere to the rigid position that the highly speculative nature of the tax mandated that its present value be zero. *See Estate of Luton v. Comm'r*, 68 T.C.M. (CCH) 1044 (1994).

C. Historical Evolution of Precedential Case Law on the Issue on Appeal

1. *Estate of Davis*—The Tax Court Case

Then, in 1998, twelve years after the TRA 1986 was enacted, the Tax Court began to relax its historical stance in keeping with the "new" statute.[19] In *Estate of Davis v. Comm'r*, 110 T.C. 530, 1998 WL 345523 (1998), the donor gave two blocks of the common stock of a closely-held holding company to his sons. The holding company owned shares of a publicly traded corporation. *Id.*

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[19] It could be speculated that the Tax Court's reversal of position in 1998 was a *fait accompli*, forced by the Commissioner's own expert appraiser witness's testimony that he included within his calculations a discount for capital gains taxes. *Estate of Davis*, 110 T.C. 530.

No liquidation of the holding company or sale of its assets was planned or contemplated on the valuation date. No tax was due and owing on the valuation date. *Estate of Davis*, 110 T.C. at 530. Nevertheless, citing section 5(b) of *Rev. Rul.* 59-60, 1959-1 C.B. at 242-43, the Tax Court determined, under an economic reality theory, that a hypothetical buyer and seller would *not* have agreed on that date on a stock price that took *no* account of the corporation's built-in capital gains tax.[20] *Id.*[21]

The Tax Court permitted discounts in *Estate of Davis*, both for a lack of marketability and for a lack of control of the shares. It did not permit a separate discount

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[20] "The value of the stock of a closely-held investment or real estate holding company, whether or not family owned, is closely related to the value of the assets underlying the stock. For companies of this type the appraiser should determine the fair market values of the assets of the company . . . . " *Rev. Rul.* 59-60, 1959-1 C.B. at 242; *see also* IV.A.2., *supra*.

[21] The court stated:

> We are convinced on the record in this case, and we find, that, even though no liquidation of [the corporation] or sale of its assets was planned or contemplated on the valuation date, a hypothetical willing seller and a hypothetical willing buyer would not have agreed on that date on a price for each of the blocks of stock in question that took no account of [the corporation's] built in capital gains tax. We are also persuaded on that record, and we find, that such a willing seller and such a willing buyer of each of the two blocks of [the corporation's] stock at issue would have agreed on a price on the valuation date at which each such block would have changed hands that was less than the price that they would have agreed upon if there had been no . . . built-in capital gains tax as of that date . . . . We have found nothing in the . . . cases on which respondent relies that requires us, as a matter of law, to alter our view . . . .

Estate of Davis, 110 T.C. at ___.

for contingent tax liability. *Id.* The Tax Court concluded that approximately $9 million of the permitted $28 million lack of marketability discount could be attributed to the built-in capital gains of the public corporation's stock.[22] *Id.* By so doing, the Tax Court conceded that built-in capital gains could now be considered, not separately, but as one of the components of the marketability discount. *Id.*

The Commissioner's position was beginning to erode. The stage was set for other courts to become involved.[23]

2. *Estate of Eisenberg* and *Estate of Welch*—The Circuit Courts of Appeal Cases

In *Estate of Eisenberg v. Comm'r*, 74 T.C.M (CCH) 1046 (1997), the donor gave away shares of stock in her closely-held corporation. She owned all 1,000 shares in a corporation whose only asset was a commercial office building. *Id.* at *1. The corporation's only activity was renting office space in the building to clients. There were no plans to sell the building or liquidate the corporation. *Id.*

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[22] *Accord Estate of Borgatello v. Comm'r*, 80 T.C.M. (CCH) 260, 264 (2000) (where, consistent with the *Estate of Davis*, the Tax Court allowed a 24% valuation discount for future corporate income taxes, but treated it as part of the aggregate 33% discount for lack of marketability); *Estate of Dailey v. Comm'r*, 82 T.C.M. (CCH) 710 (2001) (where a discount for unrealized capital gains was allowed as part of the lack of marketability discount).

[23] *See however Estate of Rodgers v. Comm'r*, 77 T.C.M. 1931 (CCH) (1999) (although the taxpayer relied upon the *Estate of Davis*, the Tax Court refused to allow a discount, also citing the *Estate of Davis*, this time for the proposition that valuation is necessarily an approximation and a matter of judgment, rather than one of mathematics).

Nevertheless, the donor sought to reduce the value of the gifted shares of the closely-held corporation to account for the fact that, if its asset was sold, the sale would trigger a tax gain to the corporation. *Estate of Eisenberg,* 74 T.C.M. at *2. The Tax Court, notwithstanding the repeal of the *General Utilities* doctrine, and still citing its pre-1986 cases, declined to allow the tax discount to the donor on the basis that it was unlikely that a hypothetical buyer would want to liquidate the corporation or sell its underlying assets on the transfer date. *Id.* at *4. "[T]he primary reason for disallowing a discount for capital gains taxes in this situation is that the tax liability itself is deemed to be speculative," therefore, its discount value should be zero. *Id.*

The Second Circuit Court of Appeals disagreed. *Eisenberg v. Comm'r,* 155 F.3d 50, 57 (2d Cir. 1998). Buoyed by the Tax Court's own recent decision in *Estate of Davis,* the Second Circuit concluded that, although no liquidation of the corporation or sale of corporate assets was imminent or contemplated at the time of the gift, the requirement of an imminent sale was unnecessary. *Id.* It was the opinion of the court that a willing buyer would demand a discount to take account of the fact that, sooner or later, the tax would have to be paid.[24] *Id.*

For the first time since the enactment of TRA 1986, the mandate by the Commissioner and the Tax Court of

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[24] The Second Circuit cited a (then) recent study surveying CPA valuation experts, attorneys involved in business transactions, and business brokers. The survey illustrated that a large majority of buyers of closely-held stock demanded a discount for contingent capital gains tax liability. *See* John Gilbert, "After the Repeal of General Utilities: Business Valuations and Contingent Income Taxes on Appreciated Assets," *Montana L. Rev.* 5 (Nov. 1995).

an imminent sale or liquidation, *notwithstanding* the revocation of the *General Utilities* doctrine, was addressed directly by a circuit court of appeal:

> The issue is not what a hypothetical willing buyer plans to do with the property, but what considerations affect the fair market value of the property he considers buying. While prior to the [TRA 1986] any buyer of a corporation's stock could avoid potential built-in capital gains tax, there is simply no evidence to dispute that a hypothetical willing buyer today would likely pay less for the shares of a corporation because of a buyer's inability to eliminate the contingent tax liability.

Eisenberg, 155 F.3d at 57.

"Further, we believe, contrary to the opinion of the Tax Court, since the *General Utilities* doctrine has been revoked by statute, a tax liability upon liquidation or sale for built-in gains is not too speculative in this case." *Id.* at 58. The Second Circuit vacated and remanded the Tax Court decision for recalculation.[25]

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[25] The Second Circuit used an example from tax treatise, Bittker & Eustice, *Federal Income Taxation of Corporations and Shareholders* ¶ 10.41 [4] n.11 (Warren, Gorham & Lamont, 6th ed. 1998), to illustrate that a hypothetical buyer and seller would allow a discount for built in capital gains tax:

> In the example, A owns 100% of the stock of X corporation, which owns one asset, a machine with a value of $1,000, and a basis of $200. Bittker assumes a 25% tax rate and points out that if X sells the machine to Z for $1,000, X will pay tax of $200 on the $800 gain. Bittker adds that if Z buys the stock for $1,000 "on the mistaken theory that the stock is worth the value of the corporate assets," Z will have lost $200 economically "because it paid too much for the stock, failing to account for the built-in tax liability (which can be viewed as the potential tax on disposition of the machine, or as the

There is dicta in *Eisenberg* to suggest, however, that it would be incorrect to conclude that the full amount of the potential capital gains tax should be used. *Id.* at 58 n.15.[26] After the *Estate of Eisenberg*, disputes between the taxpayers and the Commissioner focused upon the magnitude of the discount allowable, not the legal right of the taxpayers to claim them.[27]

In 2000, the trend continued and moved to a different circuit. *See Estate of Welch v. Comm'r*, (unpublished) 208 F.3d 213 (6th Cir. 2000).[28] In *Estate of Welch*, the decedent was a minority shareholder of two closely-held corporations. The primary assets of both corporations consisted of real property, i.e., commercial buildings rented to various tenants. The assets were subject to condemnation and sale after the decedent's death. *Id.* at *1.

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potential loss from lock of depreciation on $800 [of] basis that Z will not enjoy.") Because of Z's loss, Bittker concludes, "Z will want to pay only $800 for the stock, in which even A will have effectively 'paid' the $200 built-in gains tax."

Estate of Eisenberg, 155 F.3d at 58 n.15.

[26] Based upon the Bittker example, the Second Circuit stated that "[o]ne might conclude . . . that the full amount of the capital gains tax should be subtracted from what would otherwise be the fair market value of the real estate. This would not be a correct conclusion. In this case, we are only addressing how potential tax consequences—the capital gains tax may affect the fair market value of the share of stock appellant gifted to her relatives in contrast to the fair market value of the estate." *Estate of Eisenberg*, 155 F.3d at 58 n. 15.

[27] The Commissioner acquiesced in *Estate of Eisenberg*, 74 T.C.M. (CCH) 1046 (1997), *acq. in result*, 1999-4 I.R.B. 4.

[28] While we are aware that this case is unpublished, it is integral to our discussion and has long been included in other analyses of the issue before us.

The Tax Court denied the decedent's estate a tax discount on the basis that the estate failed to prove that liquidation of the corporations' assets was likely to occur on the valuation date. *Id.* at *3. The court so held even though the condemnation and subsequent sale were clearly foreseeable and imminent on the valuation date. *Id.*

Relying upon the rationale of the Second Circuit in *Estate of Eisenberg,* the Sixth Circuit found the Tax Court's judgment disallowing any discount in any amount erroneous as a matter of law and remanded to the Tax Court for a hearing. *Id.* at *5. The court was instructed to determine what a hypothetical, willing buyer would likely pay for the *Estate of Welch* stock on the valuation date, considering all the facts and circumstances at the time, including the built-in capital gains tax on the corporation's real estate.[29] *Id.* Similarly to the Second Circuit in the *Estate of Eisenberg,* there is language to suggest that the Sixth Circuit did not think it appropriate that the discount be on a dollar-for-dollar basis either.[30] *Id.*

While neither the Second Circuit in *Estate of Eisenberg,* nor the Sixth Circuit in the *Estate of Welch,* seemed keen on granting a 100% discount, neither court prescribed a specific alternative approach either as to the amount of the reduction or a method by which to calculate it. Now that taxpayers have historically prevailed on this issue and are entitled to a discount as a

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[29] The Tax Court had made no previous attempt to undertake this valuation discount. *Estate of Welch,* 208 F.3d at 6.

[30] *See also Martin v. Martin Bros. Container & Timber Prods. Corp.,* 241 F. Supp. 2d 815 (N.D. Ohio 2003), *aff'd without opinion,* 112 Fed. Appx. 395 (6th Cir. 2004) (unpublished).

matter of law, the issue shifts to the amount of the discount to be allowed.

3. The Fifth Circuit In *Estate of Jameson* and *Estate of Dunn*—A Further Shift in Emerging Case Law

By 2001, the issue presented itself squarely in the Fifth Circuit. In *Estate of Jameson v. Comm'r*, 267 F.3d 366 (5th Cir. 2001), the decedent owned 98% of the stock of her predeceased husband's closely-held operating company. *Id.* at 367. The company was both an operating timber company and an investment company. *Id.* at 367-69.

The Tax Court, based on its recent decision in *Estate of Davis*, concluded that some discount for built-in capital gains should be acknowledged. *Estate of Jameson*, 267 F.3d at 371. Using a net asset valuation approach, the Tax Court allowed a partial discount based upon the court's estimate of the net present value for the capital gains tax liability on the timber property that would be incurred as the timber was cut, over a nine-year period.[31] *Id.* As to the investment property, the Tax Court refused to allow any capital gains discount for that property. *Id.* at 370.

Relying on the Second Circuit case of *Estate of Eisenberg*, the Fifth Circuit in the *Estate of Jameson* concluded that the Tax Court had clearly erred in crafting its own valuation method. *Id.* at 371. The method

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[31] This nine-year period was calculated based upon assumptions furnished by the estate, i.e., a 10% annual growth to harvest rate of the timber; a 4% annual inflation rate in the value of the harvest; a 34% capital gains tax rate; and a 20% discount rate. *Estate of Jameson*, 267 F.3d at 370.

was flawed because it was based upon the Tax Court's conclusive assumption that a strategic, not a hypothetical, buyer would continue to operate the company for timber production. *Id.* at 371-72.

The Fifth Circuit determined that the first, or economically rational, purchaser of the stock *cannot* be presumed to operate the company. *Estate of Jameson*, 267 F.3d at 371-72. The rational economic actor or willing buyer would *have to take into account* the consequences of the unavoidable, substantial built-in tax liability on the property. *Id.* The economic reality was that any reasonable willing buyer would consider the company's low basis in the investment property in determining a purchase price. *Id.*

Citing internally inconsistent assumptions within the Tax Court opinion, the Fifth Circuit vacated the judgment and remanded the case back to the Tax Court. The instructions given were that the Tax Court reconsider the amount of capital gains on the operating timber property, and, to consider and allow a discount for the built-in capital gains on the investment property. *Estate of Jameson*, 267 F.3d at 372.

A year later, the Fifth Circuit went one step further in *Estate of Dunn v. Comm'r*, 301 F.3d 339 (5th Cir. 2002). At the time of her death, Mrs. Dunn owned a majority 62.96% of the stock of a family-owned corporation engaged in the rental of heavy equipment. The family company also managed certain commercial property as an investment. *Id.* at 347.

As Texas corporate law required a 66.66% interest in the voting shares to affect a liquidation, with 62.9%, Mrs. Dunn did not own a "supermajority," or 66.6%, that could force a liquidation. *Id.* The facts further indicated

that the family company planned to remain viable and in operation for some time.[32] *Id.*

Using a willing buyer-willing seller fair market value test, the Tax Court in the *Estate of Dunn*, while agreeing with the Commissioner's argument that the tax was certainly speculative, still agreed to discount the stock price by 5% of the built-in capital gains as a matter of law. *Id.* at 347. This holding was in response to the existence of a very small possibility that a hypothetical buyer would liquidate the company. The 5% discount was in lieu of the 34% reduction sought by the taxpayers. *Id.* The Tax Court concluded that it was much more likely that a hypothetical buyer would continue to operate the company. *Id.*

The Fifth Circuit disagreed emphatically with the Tax Court. In the *Estate of Dunn*, under a net asset valuation approach, the Fifth Circuit determined value by totaling the corporation's assets and subtracting its liabilities. It held that a hypothetical willing buyer-willing seller *must always be assumed* to immediately liquidate the corporation, triggering a tax on the built-in gains.[33] *Id.* at 354. Thereby substantially altering the Tax Court's fair market value test, the Fifth Circuit held, as a matter of law, that, *as a threshold assumption*, liquidation must always be assumed when calculating an asset under the net asset value approach.[34] *Id.* The Fifth

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[32] The Commissioner, continuing to adhere to his historical pre-1986 stance, took the position that the tax was "too speculative" to consider and disallowed any discount. *Estate of Dunn*, 301 F.3d at 346.

[33] *See also* Stephens, Maxfield, Lind et al., *Federal Estate and Gift Taxation* ¶ 4.02 (Warren, Gorham & Lamont, 8th ed. 2002).

[34] "[T]he 'likelihood' is 100%." *Estate of Dunn*, 301 F.3d at 350.

Circuit labeled as a "red herring" the fact that no liquidation was imminent or even likely.[35] *Id.*

Turning to the proper amount of the discount, the Fifth Circuit concluded that the value of the assets must be reduced by a discount equal to 100% of the capital gains liability, dollar for dollar.[36] *Id.* at 352. The court relied upon the assumption that, in a net asset valuation context, the hypothetical buyer is predisposed to buy stock to gain control of the company for the sole purpose of acquiring its underlying assets. *Id.* This, in turn, triggers a tax on the built-in gains.[37] *Id.* Hence, the dis-

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[35] It involves the "quintessential mixing of apples and oranges." *Estate of Dunn*, 301 F.3d at 353.

[36] The Fifth Circuit held that:

> We are satisfied that the hypothetical willing buyer of the Decedent's block of Dunn Equipment stock would demand a reduction in price for the built-in gains tax liability of the Corporation's assets at essentially 100 cents on the dollar, regardless of his subjective desires or intentions regarding use or disposition of the assets. Here, that reduction would be 34%. This is true "in spades" when, for purposes of computing the *asset*-based value of the Corporation, we assume (as we must) that the willing buyer is purchasing the stock to get the assets, whether in or out of corporate solution. We hold as a matter of law that the built-in gains tax liability of this particular business's assets must be considered as a dollar-for-dollar reduction when calculating the *asset*-based value of the Corporation, just as, conversely, built-in gains tax liability would have no place in the calculation of the Corporation's *earnings*-based value.

Estate of Dunn, 301 F.3d at 352-53 (emphasis in original). Perhaps by so doing, the court was sending a strong message to the Commissioner about capitalizing on valuation uncertainties to force enhanced compromise tax settlements for the government.

[37] The Fifth Circuit illustrated the dollar-for-dollar reduction by the following example:

count should be 100%, dollar-for-dollar. An era of valuation certainty had begun.[38]

4. Cases After the *Estate of Dunn*

In 2004, the Fifth Circuit in *Estate of Smith v. Comm'r*, 391 F.3d 621 (5th Cir 2004), was asked to decide the issue of whether or not, for estate tax purposes, the value of a decedent's individual retirement accounts (IRAs), containing marketable stocks and bonds, should be reduced by the amount of potential income tax liability of the beneficiaries upon distribution from the accounts. *Estate of Smith*, 391 F.3d at 626. While acknowledging the recent trend of considering potential tax liability in valuation cases, the Fifth Circuit declined to extend *Estate of Davis* and its progeny, including the

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Buyer B wants an assemblage of assets identical to Corporation C's assets. Those assets are worth $1 million on the open market but are depreciated on C's books to a tax basis of $500,000. B has two options: (1) He can buy the assets from C for $1 million and depreciate them to zero over, e.g., seven years (or buy them on the open market and have the same cash flow and tax experience), leaving C to pay its own 34% tax ($170,000) on its gain; or (2) he can buy C's stock, get no depreciation deductions other than, at the corporate level, to the extent the asset are further depreciable, and have a 34% built-in corporate tax liability at sale of the assets. Surely a buyer of the stock rather than the asset would insist on a price reduction to account for the full amount of the built-in gain tax and the loss of the depreciation opportunity.

Estate of Dunn, 301 F.3d at 353 n.23; *see also* n.42 *infra*.

[38] In at least one case, the Commissioner has taken an inconsistent position as to dollar-for-dollar recognition. In *Simplot v. Comm'r*, 112 T.C. 130, 166 n.22, 1999 WL 152610 (1999), *rev'd on other grounds* 249 F.3d 1191 (9th Cir. 2001), the Commissioner presented testimony of an expert witness who concluded that, when valuing a closely-held corporation's interest in publicly traded stock, full recognition of built-in capital gains was appropriate.

Estate of Dunn, to the valuation of IRAs held by a decedent.[39] *Id.*

Most recently, in *Estate of McCord v. Comm'r*, 461 F.3d 614 (5th Cir. 2006), another Fifth Circuit case, the "trend" continues. The case presented an issue of first impression regarding a donee's contingent liability for additional estate taxes after receipt of the gift. *Id.* at 630-32.

In *Estate of McCord*, the Commissioner asserted in a notice of deficiency that donor taxpayers had understated the fair market value of their gifted partnership interests on their gift tax returns. *Id.* at 621. The Commissioner claimed that this error resulted from the donor taxpayers' discounting the fair market value of those gifted interests by the mortality-based, actuarially-calculated present value of the donees' assumed obligations for additional estate taxes. *Id.*

Finding no error in undervaluation, the Fifth Circuit in *Estate of McCord*, citing *Estate of Dunn*, stated:

> For purposes of our willing buyer/willing seller analysis, we perceive no distinguishable difference between the nature of the capital gains tax and its rates on the one hand and the nature of the estate tax and its rates on the other hand. Rates and particular

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[39] The value of an IRA should not reflect the potential income tax liability of the beneficiaries upon distribution from the accounts, as an IRA is a different asset, with different tax consequences. *See also Estate of Kahn v. Comm'r*, 125 T.C. No. 11, 125 T.C. 227, 2005 WL 3081656 (2005) (where the Tax Court declined to extend *Estate of Davis* and its progeny, including *Estate of Dunn*, to IRAs). With IRAs, the tax does not survive the transfer to an unrelated third party, unlike capital gains tax potential which does survive the transfer. *See Estate of Smith*, 391 F.3d at 629.

> features of both the capital gains tax and the estate tax have changed and likely will continue to change with irregular frequency; likewise, despite considerable and repeated outcries and many aborted attempts, neither tax has been repealed. Even though the final amount owed by the Taxpayer as *gift* tax on their January 1996 gifts to non-exempt donees has yet to be finally determined (depending, as it does, on the final results of this case), we are satisfied that the transfer tax law and its rates that were in effect when the gifts were made are the ones that willing buyer would insist on in applying in determining whether to insist on, and calculate a discount for § 2035 estate tax liability.

Estate of McCord, 461 F.3d at 630.

The Fifth Circuit thereby extended the rationale of *Estate of Davis* to a gift tax case involving contingent estate taxes.[40]

D. Applying the Fifth Circuit *Estate of Dunn* Rationale to the Present Appeal

Juxtaposed against the backdrop of this emerging case law, the question before the Tax Court in this case, and now before us, is what was the value of Jelke's 6.44% interest in CCC on March 4, 1999? Which dollar figure do we use to discount the fair market value of CCC's securities for built-in capital gains on March 4,

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[40] The Fifth Circuit, in the *Estate of McCord,* was never asked to decide whether or not the dollar-for-dollar analysis of the *Estate of Dunn* applied in the context of contingent estate taxes generated by a gift, as the maximum amount that the donor taxpayers had claimed on their gift tax returns was a discount only for the present value of the date-of-gift of the contingent estate tax obligations assumed by the donees. *See Estate of McCord,* 461 F.3d at 631.

1999? Is it dollar-for-dollar, as the estate contends, under the rationale set forth in 2002 by the Fifth Circuit in the *Estate of Dunn*, or $51 million? Or is it the present value of the capital gains indexed over a sixteen-year period, as the Commissioner contends, or $21 million?

Is the Commissioner's present value approach incomplete and inconsistent, as the estate contends, as CCC's securities will very likely appreciate over this time period, thereby increasing capital gains tax liabilities and undermining the rationality of a present value approach? What if the value of CCC's securities were to decline over this sixteen-year period, and, concomitantly, the capital gains tax also declined?

Is the Commissioner correct in contending that the *Estate of Dunn*'s threshold "assumption of liquidation" is unreasonable and unrealistic in the present case as CCC is precluded from liquidation until 2019? Does such a minority interest such as we have here, with no power to "force" CCC's liquidation, render the *Estate of Dunn* distinguishable, as it concerned a majority interest? Does it matter that the corporation in the *Estate of Dunn* was primarily an operating company, while CCC is exclusively an investment holding company?

Recently, on other issues and other facts, in *Estate of Blount v. Comm'r*, 428 F.3d 1338 (11th Cir. 2005), we were also asked to determine the fair market value of shares of stock in a closely-held corporation owned by a decedent for estate tax purposes.[41] *Id.* An economic reality approach to valuation, in its dicta, is referenced:

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[41] Insurance proceeds paid to a company upon a shareholder's death are not to be included in calculating the company's fair market value due to the company's contractual obligation to buy the decedent's shares. *Estate of Blount*, 428 F.3d at 1345.

"To suggest that a reasonably competent business person, interested in acquiring a company, would ignore a $3 million liability strains credulity and defies any sensible construct of fair market value." *Id.* at 1346. To properly reflect the economic realities of the transaction, in other words, it is important to take liability costs into account when negotiating a market-supported price for a share of a company's stock, such as CCC, for example.

In our case, why would a hypothetical willing buyer of CCC shares *not* adjust his or her purchase price to reflect the entire $51 million amount of CCC's built-in capital gains tax liability? The buyer could just as easily venture into the open marketplace and acquire an identical portfolio of blue chip domestic and international securities as those held by CCC. Yet the buyer could accomplish this without any risk exposure to the underlying tax liability lurking within CCC due to its low cost basis in the securities.[42]

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[42] Consider the following example:

> [T]wo corporations each owning a portfolio of publicly traded securities having the same aggregate fair market value. Where these two companies differ concerns the purchase price each had to pay to amass the respective portfolios. The higher investment cost for one of the corporations will produce a lower corporate income tax liability in comparison to the other corporation even though each corporation, should it decide to, sells the portfolio for the same price. In choosing which corporation to acquire, little doubt exists that a prospective purchaser of the stock of either of these corporations would be unwilling to pay the same price for each corporation knowing full well the potential for a greater income tax bite for the corporation with the lower investment cost in its assets.

Mark R. Siegel, "Recognizing Asset Value and Tax Basis Disparities to Value Closely-held Stock," 58 *Baylor L. Rev.* 861, 862-63 (Fall 2006); *see also supra* note 37.

Here, the Tax Court distinguished the majority interest held by the decedent in the *Estate of Dunn* from our case on the basis that the Jelke estate's minority interest was single-handedly insufficient to "force" a liquidation on its own. The Tax Court chose a sixteen-year period to reflect when the corporation would reasonably incur the tax. This distinction is not persuasive to us. We are dealing with hypothetical, not strategic, willing buyers and willing sellers. As a threshold assumption, we are to proceed under the arbitrary assumption that a liquidation takes place on the date of death. Assets and liabilities are deemed frozen in value on the date of death and a "snap shot" of value taken. Whether or not a majority or a minority interest is present is of no moment in an assumption of liquidation setting.

The Commissioner also argues that the *Estate of Dunn* is distinguishable on its facts as the company being valued was primarily an operating company and CCC is an investment holding company. As the company in the *Estate of Dunn* was both an operating company and an investment company, the Fifth Circuit was forced to use two different methods of valuation, an earnings-based valuation method for the operating side of the company, and a net asset valuation method for the investment side. It assigned a percentage weight to them of 85% and 15%, respectively. *Estate of Dunn*, 301 F.3d at 358-59.

Here, CCC was solely an investment holding company. We need examine only the *Estate of Dunn* analysis as it applies to the net asset valuation method used in valuing investment holding companies; there is no need for weighting. The Commissioner's argument on this point is without merit.

It is only recently that, the Tax Court in the *Estate of Davis,* the Second Circuit in the *Estate of Eisenberg* and the Sixth Circuit in the *Estate of Welch,* courts are receptive to the concept that some sort of discount for capital gains tax liability exists.[43] Yet, in the more than twenty years since the TRA 1986 was enacted, none of these three cases provide any precise rules for calculating the downward adjustment with any specificity, nor give guidance to tax practitioners in future cases.

The Fifth Circuit in the *Estate of Dunn* is the first court to emerge with a precise valuation approach as to the amount of the reduction and how to calculate it. As a threshold matter, the court creates the arbitrary assumption that all assets are sold in liquidation on the valuation date, and 100% of the built-in capital gains tax liability is offset against the fair market value of the stock, dollar-for-dollar.[44] *Estate of Dunn,* 301 F.3d at 352-54.

Cases prior to the *Estate of Dunn,* prophesying as to when the assets will be sold and reducing the tax liability to present value, depending upon the length of time discerned by the court over which these taxes shall be paid, require a crystal ball. The longer the time, the lower the discount. The shorter the time, the higher the discount.

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[43] We are aware that dicta in the courts of appeal cases indicates a discount of less than 100%.

[44] Even the Commissioner in this case agrees that the fair market value of CCC's assets and liabilities must be frozen on the valuation date. *See Red Brief,* at 41. Other than to describe the Fifth Circuit's methodology in *Estate of Dunn* as "unreasonable" and "unrealistic," the Commissioner provides no authority in support of his position.

The downside of this approach is that, not only is it fluidly ethereal, it requires a type of hunt-and-peck forecasting by the courts. In reality, this method could cause the Commissioner to revive his "too speculative a tax" contentions made prior to the *Estate of Davis* in 1998. This methodology requires us to either gaze into a crystal ball, flip a coin, or, at the very least, split the difference between the present value calculation projections of the taxpayers on the one hand, and the present value calculation projections of the Commissioner, on the other.

We think the approach set forth by the Fifth Circuit in the *Estate of Dunn* is the better of the two. The estate tax owed is calculated based upon a "snap shot of valuation" frozen on the date of Jelke's death, taking into account only those facts known on that date. It is more logical and appropriate to value the shares of CCC stock on the date of death based upon an assumption that a liquidation has occurred, without resort to present values or prophesies.

The rationale of the Fifth Circuit in the *Estate of Dunn* eliminates the crystal ball and the coin flip and provides certainty and finality to valuation as best it can, already a vague and shadowy undertaking. It is a welcome road map for those in the judiciary, not formally trained in the art of valuation.

The *Estate of Dunn* dollar-for-dollar approach also bypasses the unnecessary expenditure of judicial resources being used to wade through a myriad of divergent expert witness testimony, based upon subjective conjecture, and divergent opinions. The *Estate of Dunn* has the virtue of simplicity and its methodology provides

a practical and theoretically sound foundation as to how to address the discount issue.

The Fifth Circuit preempted its critics by stating: "As the methodology we employ today may well be viewed by some (valuation) professionals as unsophisticated, dogmatic, overly simplistic, or just plain wrong, we consciously assume the risk of incurring such criticism from the business appraisal community . . . In this regard, we observe that on the end of the methodology spectrum opposite *oversimplification* lies *over-engineering*." *Estate of Dunn*, 301 F.3d at 358 n.36 (emphasis in original).

This type of "economic reality approach" mimics the marketplace and places a practical, transactional overlay upon the proverbial willing buyer-willing seller analysis. It allows the issue to conform to the reality of the depressing economic effect that the lurking taxes have on the market selling price. The hypothetical willing buyer is a rational, economic actor. Common sense tells us that he or she would not pay the same price for identical blocks of stock, one purchased outright in the marketplace with no tax consequences, and one acquired through the purchase of shares in a closely-held corporation, with significant, built-in tax consequences.

This 100% approach settles the issue as a matter of law, and provides certainty that is typically missing in the valuation arena. We thereby follow the rationale of the Fifth Circuit in the *Estate of Dunn*, that allows a dollar-for-dollar, $51 million discount for contingent capital gains taxes in valuing CCC on the date of Jelke's death, and his 6.44% interest therein. This result prevents grossly inequitable results from occurring and

also prevents us, the federal judiciary, from assuming the role of arbitrary business consultants.[45]

V. CONCLUSION

Based upon the foregoing discussion, as a matter of law, under a *de novo* review, we vacate the judgment of the Tax Court and remand with instructions that the Tax Court recalculate the net asset value of CCC on the date of Jelke's death, and his 6.44% interest therein, using a dollar-for-dollar reduction of the entire $51 million in built-in capital gains tax liability, under the assumption that CCC is liquidated on the date of death and all assets sold.

VACATED and REMANDED with INSTRUCTIONS.

CARNES, Circuit Judge, dissenting:

The tax code is nowhere near the center of my intellectual life, and generally I find estate tax law about as exciting as Hegel's metaphysical theory of the identity of opposites. There is, however, more involved in this case than just the estate tax issue presented, which is how to determine the fair market value of the decedent's distinctly minority interest in CCC, a closely held corporation whose assets consist primarily of marketable securities with a built-in capital gains tax liability.

The broader principles implicated by the majority opinion are timeless. They were discussed by Teddy Roosevelt at the close of the century before last:

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[45] Given the maximum capital gains tax rate at this writing of 15% for future cases, one can only speculate that the maximum capital gains tax rate will not again approach the 34% range seen in previous cases.

> I wish to preach not the doctrine of ignoble ease but the doctrine of the strenuous life; the life of toil and effort; of labor and strife; to preach that highest form of success which comes not to the man who desires mere easy peace but to the man who does not shrink from danger, from hardship, or from bitter toil, and who out of these wins the splendid ultimate triumph.

Vice President Theodore Roosevelt, The Strenuous Life, Address before the Hamilton Club in Chicago, Illinois (Apr. 10, 1899), *in The Penguin Book of Twentieth-Century Speeches* 1 (Brian MacArthur ed., 1992). By adopting and extending the arbitrary assumption rule of least effort from *Estate of Dunn v. Comm'r*, 301 F.3d 339 (5th Cir. 2002), the majority gives in to the judicial equivalent of the doctrine of ignoble ease. To avoid the effort, labor, and toil that is required for a more accurate calculation of the estate tax due, the majority simply assumes a result that we all know is wrong. We can do better than that. The Tax Court did.

The corporation whose assets are being valued in this case is a holding company with a portfolio of widely traded securities whose value can be readily determined. *Estate of Jelke v. Comm'r*, No. 3512-03, 2005 WL 1277407, at *1, 3 (T.C. May 31, 2005). The rate at which the company had liquidated the securities it held in the five years before the decedent's death is also known to one one-hundredth of a percent. *Id.* at *2, 8. The parties agreed that the value of the company's net assets at the time of death is what counts, and they agreed that the market value of the securities CCC held at the time of death should be reduced by some amount for the capital gains tax liability attached to the securities. *Id.* at

*3. That is what the law provides. *See* 26 C.F.R. § 20.2031-1(b) ("The value of every item of property includible in a decedent's gross estate . . . is the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or to sell and both having reasonable knowledge of relevant facts."); *Estate of Blount v. Comm'r*, 428 F.3d 1338, 1346 (11th Cir. 2005). The disagreement is over how to calculate that reduction in value. *Jelke*, 2005 WL 1277407, at *3 ("[T]he parties differ as to the amount of the reduction from the value for the potential capital gain tax liability that would arise upon sale of the marketable securities held by the corporation.").

The estate contends that the full amount of the capital gains tax liability should be deducted from the value of the securities as though they had been sold at the time of death, even though they were not. *Id.* The IRS wants the capital gains reduction calculated based on projecting the average rate of past liquidation forward and then discounting the taxes that will come due in the future back to present value at the time of death. *Id.*

The Tax Court summarized the estate's contention, which was put forward by its expert, Mr. Frazier, as follows:

> After discussing several methods, Mr. Frazier used what he described as a combination of the market and asset approaches. Mr. Frazier used the market approach to value CCC's securities. Purporting to rely on the asset approach to valuation, Mr. Frazier then reduced the total of the market prices for CCC's securities by the liabilities shown on CCC's books and the tax liability that would have been in-

curred if all of CCC's securities had been sold on decedent's date of death. Mr. Frazier did not make adjustments to the tax liability for the possibility that sales of CCC's securities would have occurred after decedent's date of death. In other words, Mr. Frazier relied on the net asset method to employ an assumption of liquidation as of the valuation date, an event which would trigger recognition of $51,626,884 in capital gain tax. This method produced a $137,008,949 [ ] value for CCC. Mr. Frazier then computed an undiscounted value of $8,823,062 for decedent's 6.44-percent interest (3,000 of 46,585.51 shares) held in trust.

Id. at *8.

The Tax Court summarized the IRS's contention, put forward by its expert, Mr. Shaked, as follows:

Respondent's expert, Mr. Shaked, started with the same market value of CCC's securities. Mr. Shaked then reduced the assets by liabilities, but he used a different approach from Mr. Frazier's in arriving at a reduction for the built-in capital gain tax liability. First, he computed CCC's average securities turnover by reference to the most recent data (1994-98). Using that data, Mr. Shaked computed a 5.95-percent average annual turnover derived from the parties' stipulated asset turnover rates for 1994-98. Mr. Shaked believed that the 5.95-percent rate was conservative, because the turnover trend was generally decreasing. The use of the 5.95-percent turnover rate results in the capital gain tax's being incurred over a 16.8-year period (100 percent divided by 5.95 percent).

> Mr. Shaked then divided the $51,626,884 tax liability by 16 years to arrive at the average annual capital gain tax liability that would have been incurred each year over this 16-year period-$3,226,680.25 ($51,626,884 divided by 16). Next, he selected a 13.2-percent discount rate based on the average annual rate of return for large-cap stocks in the period from 1926 to 1998, as described in Ibbotson Associates Stocks, Bonds, Bills & Inflation, 1999 Yearbook (Ibbotson 1999). He then computed the present value of the $3,226,680.25 annual tax liability discounted over 16 years using a 13.2-percent interest rate to arrive at a present value for the total capital gain tax liability of $21,082,226. By reducing the $188,635,833 net asset value by the $21,082,226 future tax liability, Mr. Shaked arrived at a $167,553,607 value for CCC. Finally, Mr. Shaked concluded that the undiscounted value for decedent's 6.44-percent interest in CCC was $10,789,164 in contrast to Mr. Frazier's undiscounted value of $8,823,062. This difference reflects numerically the parties' differing approaches to the amount of capital gain tax that should be used to reduce the net asset value of CCC.

Id. at *8-9 (footnote omitted).

The Tax Court adopted the IRS's real value approach, even though it is more complicated than the estate's simple but arbitrary assumption that all of the assets were sold at the time of death. *Id.* at *11-12. The court chose the real value approach because it produces a result closer to the actual value of the company's assets, which in turn leads to a more accurate determination of the sales price a willing buyer and seller would

agree on for the shares of the holding company that Jelke owned on the date of his death. *Id.*

While the real value approach is not perfect and itself makes some assumptions—such as the past rate of liquidation continuing in the future—it produces a more accurate result than the arbitrary assumption method because it more closely reflects the economic interests of those who control the company. The death of one who holds only 6.44 percent of the shares of a holding company, *id.* at *2, that has been producing an average annual rate of return of more than 23 percent on securities, *id.*, and that has substantial built-in capital gains taxes, *id.* at *3, is not going to prompt the liquidation of all of the company's assets. It would be economically foolish for the majority shareholders to gut the golden goose and bring down on their heads the embedded capital gains tax liability simply because of the death of a minority shareholder, an event of no relevance to their economic interests.

The majority's approach assumes that the holding company was liquidated on the date of Jelke's death, and therefore all of its built-in capital gains were incurred (and therefore passed on to its shareholders) immediately. Maj. Op. at 1333. The majority makes that assumption despite the fact that: historically the company has sold only 5.95 percent of its investments and therefore precipitated only that small portion of the total built-in capital gains liability per year, *Jelke*, 2005 WL 1277407, at *8; the company is earning an annual return of more than 23 percent on its portfolio investments, *id.* at *2; and, "[a]s of the date of decedent's death, CCC's board of directors had no plans to liquidate an appreciable portion of CCC's portfolio, and they intended to op-

erate CCC as a going concern," *id.* Under these circumstances, the notion that the company would suddenly dispose of its highly profitable portfolio, ending the enviable earnings stream, and inflicting a substantial capital gains tax on its shareholders is preposterous. The fact that Jelke died does not make it any less so.

The death of a human being is profoundly important to the person who dies, but it matters not one whit to the laws of economics, which dictate the self-interest of the living. Because the interests of the majority shareholders did not change when Jelke died, the only reasonable expectation is that the holding company will continue to be run as it was before that immaterial event occurred. Yet, the majority insists on pretending that contrary to the economic interests of its shareholders, and contrary to everything that has come before, the company must be assumed to have sold all of its securities on the date of Jelke's death.

The majority suggests that subtracting the entire $51 million in embedded capital gains liability from the $188.6 million value of the company's portfolio is the best approach, because "why would a hypothetical willing buyer of CCC shares *not* adjust his or her purchase price to reflect the entire $51 million amount of CCC's built-in capital gains tax liability?" Maj. Op. at 1331. The answer, of course, is that the buyer would adjust downward the price he was willing to pay in order to reflect that liability, but the buyer could not reasonably expect the seller to agree to a price that ignored completely the time value of money. No rational seller would accept a price that subtracted the entire amount of the future tax liability as though it were due immediately, when that liability will almost certainly be spread

out over future years instead—the next 16.8 years if existing practices continue. *Jelke*, 2005 WL 1277407, at *8. Assets with liabilities that will not come due until future years are worth more than those with the same amount of liabilities that are due immediately.

Any rational being would prefer to pay $51 million in taxes spread out over the next 16.8 years, which is how long it would take for the embedded tax liability to come fully due under the company's historical rate of liquidation, instead of paying the entire $51 million immediately. Ask yourself: If you had the choice would you prefer to pay the taxes you are going to owe over the next 16 or so years in advance, right now, or would you choose to pay those taxes only when they come due in the future? The majority would assume, because it makes the calculations easier, that you would choose to pay all of your future taxes now.

When tax liabilities and payments are spread out over future years a taxpayer is able to use the unpaid funds to earn more money until the taxes actually do come due. When the amount involved is $51 million and the portion of it that can be invested declines at a rate of only 5.95 percent per year, the interest, dividends, and capital gains that can be earned using that slowly declining balance (and the accumulated earnings that flow from it) are enormous. Ask yourself: Would you put any value on the earnings you could get from investing a declining balance of $51 million, which diminishes at the rate of only 5.95 percent per year, or would you think that all of the money you could earn with the use of that declining principal over the next 16 years would be negligible? The majority's assumption makes sense only to those who would place no value on the earnings that

could be made with the use of $51 million in investment principal as it declines at a rate of 5.95 percent each year for the next 16.8 years.

The majority asserts that a buyer "would not pay the same price for identical blocks of stock, one purchased outright in the marketplace with no tax consequences, and one acquired through the purchase of shares in a closely-held corporation." Maj. Op. at 1333. Of course not. But we are not talking about the same price. We are talking about a price between two extremes. One extreme is the majority's approach, which assumes that tax consequences that are likely to come due gradually, over a period of 16.8 future years, have the same effect on price as those that are due immediately. The other extreme, which is the straw man the majority erects, assumes that tax consequences have no effect at all on price. But that is not the position the Tax Court took. Instead, the Tax Court position recognizes that the embedded tax liability will affect price and calculates how much effect it will have, taking into account the size of the tax liability and when it is likely to become due. The Tax Court's calculation, which is based on the facts, produces a result that is closer to reality than the majority's assumption of instant liquidation.

To its credit, the majority concedes that its approach is arbitrary. The majority describes its operating premise that a holding company would instantly liquidate its entire investment portfolio on the date of a minority shareholder's death as an "arbitrary assumption." Maj. Op. at 1332. Seeking to justify its approach, the majority argues that being arbitrary "provides certainty and finality" and "bypasses the unnecessary expenditure of judicial resources" that is required to make a more real-

istic calculation. *Id.* at 1333. Indeed, it does. Of course, the same could be said about any arbitrary assumption, including one that the securities had no value at all or that the capital gains tax liability would never actually be paid for some unknown reason. Either of those arbitrary assumptions would also avoid the unnecessary expenditure of judicial resources while providing certainty and finality. Once the doctrine of ignoble ease and seductive simplicity is allowed to reign, there is no end to the shortcuts that can be taken.

If the majority's approach is good, the good it provides should not be confined to estate tax law. It should be shared with all areas of the law. To take one example of how the majority's approach can work its magic, consider the daunting task of calculating the lost future earnings award in the case of one who has been disabled or killed by a tortfeasor. In *Culver v. Slater Boat Co.*, 722 F.2d 114 (Former 5th Cir. 1983) (en banc), our predecessor Court held that: "The calculation of damages suffered either by a person whose personal injuries will result in extended future disability or by the representatives of a deceased person involves four steps: estimating the loss of work life resulting from the injury or death, calculating the lost income stream, computing the total damage, and discounting that amount to its present value." *Id.* at 117. Doing all of that requires a lot of judicial effort as even a cursory reading of the *Culver* opinion shows.

But no longer is all that bother necessary. The parties need not quarrel over, and courts need not concern themselves with, all the variables that go into calculating a fair award for lost future earnings. After all, the quest for a best estimate of economic reality in such a case is,

in the majority's view: "fluidly etheral," it involves "hunt-and-peck forecasting," it is like "flip[ping] a coin," and it is no better than "gaz[ing] into a crystal ball." Maj. Op. at 1332.

The alternative to its arbitrary assumption, the majority says, is having courts "prophesying." *Id.* So it is, and so it has been throughout the history of our judicial system, because sometimes prophesying is necessary. As is so often the case, the words of Justice Holmes are instructive. In *Ithaca Trust Co. v. United States*, 279 U.S. 151, 49 S. Ct. 291, 73 L. Ed. 647 (1929), he wrote for the Court, holding that for the purposes of calculating an estate's charitable deduction for bequeathing the remainder interest in a trust, the value of the trust assets given to the charity had to be discounted by the decedent's widow's life estate in the trust. The value of the life estate, in turn, had to be calculated based on the statistically probable (or as our majority would say, "prophesied") length of the widow's life. Holmes explained:

> [T]he value of property at a given time depends upon the relative intensity of the social desire for it at that time, expressed in the money that it would bring in the market. Like all values, as the word is used by the law, it depends largely on more or less certain prophecies of the future, and the value is no less real at that time if later the prophecy turns out false than when it comes out true.

Id. at 155, 49 S. Ct. at 292 (citations omitted); *accord* Rev. Rul. 59-60 § 3.03, 1959-1 C.B. 237 ("Valuation of securities is, in essence, a prophesy as to the future and must be based on facts available at the required date of appraisal."); *see also Culver*, 722 F.2d at 123 ("Courts

are not prophets and juries are not seers. In making awards to compensate injured plaintiffs or the dependents of deceased workers for loss of future earnings, however, these fact-finders must attempt, in some degree, to gauge future events.").

From now on, the majority opinion indicates, there are to be no more prophesies. For example, in cases like *Culver* we can just arbitrarily assume that whenever someone dies or is injured the value of the future earnings they have lost is $1 million, or $10 million, or zero dollars. Or we can take the decedent's previous year's earnings, if it is not too much trouble to figure them out, and multiply that amount by some arbitrary number (perhaps the number of years the dead man's father or grandfather lived), and we can forget about discounting future losses to present value. Which dollar figure or multiple of the last year of earnings that we arbitrarily assume will not matter, except of course to the parties themselves and to those who believe that the law ought to strive for results that seek to approximate reality, even when it requires a little prophesy.

The advantages of the majority's method flow from the simplicity that comes from being arbitrary. The more arbitrary the assumption the less that application of it will be hindered by the reality of bothersome facts which are burdensome to find. Adopting this method will "provide[ ] certainty and finality" and "bypass[ ] the unnecessary expenditure of judicial resources," relieving courts of the burden of doing what courts are designed to do, which is find facts and apply the law to them. Maj. Op. at 1333. Writing the doctrine of ignoble ease into the law will have its advantages.

Of course, we are going to have to overrule some precedent, or perhaps in keeping with the majority's decisional motif we can just arbitrarily assume that the conflicting precedent does not exist. The precedent established by the en banc Court in the *Culver* case nearly a quarter of a century ago will have to be thrown overboard, but it is just an admiralty decision anyway.

We will also have to get rid of the *Meader ex rel. Long v. United States*, 881 F.2d 1056 (11th Cir. 1989), precedent and decisions like it. The *Meader* case arose under the Federal Tort Claims Act and involved the calculation of an award for future medical expenses and lost future earnings. We held, among other things, that "[i]t is a settled principle of law that [such] an award . . . must be adjusted to its present value to account for two factors: first, the interest the award will earn before it is used to pay for medical expenses or to replace earnings; second, the depreciation the award will suffer over time on account of inflation." *Meader*, 881 F.2d at 1057-58; *see also Dempsey ex rel. Dempsey v. United States*, 32 F.3d 1490, 1492 (11th Cir. 1994) (FTCA medical malpractice case stemming from injuries to a newborn, required not only calculating an award for future medical expenses but also calculating a dollar value for the parent's "loss of society and affection of the child" and their loss of the child's services in the future).

Then there is our decision of just a few months ago in *Advanced Telecommunication Network, Inc. v. Allen (In re Advanced Telecommunication Network, Inc.)*, 490 F.3d 1325 (11th Cir. 2007). There the bankruptcy court had been faced with the difficulty of valuing a company's contingent liability arising from pending litigation against it in state court. Not sure how the result of

that litigation against the company could have been predicted, the bankruptcy court took the easy way out and arbitrarily assumed that the value of the contingent liability was zero. *Id.* at 1335-36. In reversing, we explained:

> Although it may be true, as the bankruptcy court put it, that "no one could have predicted this result with any reasonable certainty," such a precise prediction was not required. The court was instead required to calculate the present value of the liability—the expected cost of the liability times the estimated chance of it ever occurring. Unless either the expected cost or the chances of it occurring are equal to zero (that is, the liability is costless, or the chances of it happening are negligible), the estimated value should be more than zero.

Id. at 1335 (emphasis omitted).

The majority approach in the present case cannot be reconciled with our holding in the *Advanced Telecommunication* case. Requiring a district court to predict the amount of damages that may be awarded in a pending lawsuit and then to discount that amount by its estimate of the chance of a liability verdict is, the majority here would say, equivalent to "flip[ping] a coin" and is no better than "gaz[ing] into a crystal ball." Maj. Op. at 1332. So, the *Advanced Telecommunication* decision, like so many others of ours that require estimating present value based on predictions about future events, will have to go. All of those prior precedents will have to yield to the easy arbitrary assumption method of valuation, to the judicial equivalent of the doctrine of ignoble ease.

Teddy Roosevelt is not the only one who extolled the virtue of toil and effort. Henry James once advised a young friend that, "I have in my own fashion learned the lesson that life is effort, unremittingly repeated, and . . . I feel somehow as if real pity were for those who had been beguiled into the perilous delusion that it isn't." Letter from Henry James to Charles Eliot Norton (May 6, 1872), *in* 1 *Henry James Letters, 1843-1875,* at 276 (Leon Edel ed., 1974). I dissent from the majority's perilous delusion.

APPENDIX B

UNITED STATES TAX COURT

Docket No. 3512-03
TC Memo. 2005-131

ESTATE OF FRAZIER JELKE III, DECEASED, WACHOVIA BANK, N.A., F.K.A. FIRST UNION NATIONAL BANK, PERSONAL REPRESENTATIVE

v.

COMMISSIONER

Date: May 31, 2005

MEMORANDUM FINDINGS OF FACT AND OPINION

GERBER, Chief Judge: Respondent determined a $2,564,772 deficiency in estate tax. After concessions,[1] the issue for our consideration concerns the fair market value of decedent's interest in a closely held corporation,

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[1] The parties agree that the gross estate should be increased by decedent's right to receive a $116,784 income tax refund for 1999 and decreased by net administrative expenses of $23,680.

and in particular, the reduction, if any, for built-in long-term capital gain tax liability, and discounts for lack of marketability and control.

FINDINGS OF FACT[2]

Frazier Jelke III (decedent) died on March 4, 1999, at a time when his legal residence was in Miami, Florida. Wachovia Bank, N.A., f.k.a. First Union National Bank (Wachovia), was appointed personal representative of decedent's estate. At the time the petition was filed, Wachovia maintained a business office in Deerfield Beach, Florida, and its principal office in North Carolina.

Commercial Chemical Co. of Tennessee, a chemical manufacturing company, was incorporated on August 16, 1922, and Oleoke Corp. was incorporated on December 7, 1929, in Delaware. On or about October 4, 1937, Oleoke Corp. changed its name to Commercial Chemical Co. (CCC) and acquired the company's assets. Until 1974, CCC manufactured products, including calcium arsenate and arsenic acid. During 1974, CCC sold its chemical manufacturing business assets to an unrelated third party. Since that time, CCC's only activity has been to hold and manage investments for the benefit of its shareholders. CCC has at all relevant times been a C corporation for Federal income tax purposes.

CCC is closely held (through trusts) by related Jelke family members. On March 4, 1999, the date of decedent's death, decedent owned 3,000 shares of common stock (a 6.44-percent interest) in CCC through a revocable trust. The other CCC shareholders were irrevocable

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[2] The parties' stipulations of fact are incorporated by this reference.

trusts holding interests in CCC ranging in size from 6.181 percent to 23.668 percent. The terms of the Jelke family trusts did not prohibit the sale or transfer of CCC stock.

Decedent held beneficial interests in three trusts in addition to the one holding the CCC stock to be valued. One of the three provided income for decedent's and his sisters' benefit and was to terminate upon the death of the last survivor. Decedent's sisters were 59 and 65 at the time of his death. A second trust provided income to decedent and his two sisters and was to terminate on March 4, 2019. Finally, a trust document created three more trusts with decedent and each of his two sisters as individual beneficiaries. Each of the separate trusts was to terminate upon the beneficiary's death, at which time the assets were to be distributed to the beneficiary's issue. Wilmington Trust Corp. (Wilmington Trust) was the trustee of all but one of the Jelke family trusts. The trusts for which Wilmington Trust was trustee collectively owned 77.186 percent of the outstanding stock of CCC, including decedent's 6.44-percent interest. From 1988 to the time of the trial in this case, there had been no sales or attempts to sell CCC stock.

CCC's portfolio was well managed by experienced individuals. Wilmington Trust provided custodial and advisory services at a charge of 0.26 percent of asset value, and a stockholder-elected board of directors (none of whom was a shareholder) managed CCC. The shareholders of CCC were not allowed to participate in the operation or management of CCC. In addition, the trust beneficiaries showed little interest in participating in CCC, attending about 12 board meetings over 20 years.

Likewise, trust beneficiaries did not attend CCC stockholders meetings.

CCC's primary investment objective was long-term capital growth, resulting in low asset turnover and large unrealized capital gains. As of the date of decedent's death, CCC's board of directors had no plans to liquidate an appreciable portion of CCC's portfolio, and they intended to operate CCC as a going concern. The payment of dividends to CCC's shareholders steadily rose from $12.35 a share in 1974 to $34 a share in 1999. CCC's asset turnover for 1994 to 1998 was:

1994	*1995*	*1996*	*1997*	*1998*
6.74%	5.06%	4.66%	9.80%	3.48%

CCC's net asset value increased from $59.5 million at the end of 1994 to $139.0 million at the end of 1998, corresponding to an average annual increase that exceeded 23 percent. On the date of decedent's death, the net asset value (assets less liabilities) of CCC was $188,635,833, as follows:

Assets	
Marketable securities	$178,874,899
Money market funds	11,782,091
Accounts receivable	53,081
Furniture and fixtures	2,665
Petty case, misc.	54,244
Total assets	190,766,908
Liabilities	
General liabilities	679,170
Current income taxes	1,451,977
Total liabilities	2,131,147

Net assets	188,635,833

CCC's securities portfolio, if sold on the valuation date, would have produced a capital gain tax liability of $51,626,884. The $188,635,833 net asset value, as of the date of decedent's death, did not include any reduction for any potential tax liability.

As of the date of decedent's death, the composition of CCC's securities portfolio was 92 percent domestic equities and 8 percent international equities. CCC's portfolio comprised mostly large-cap stocks, devoting only a small portion of its portfolio to emerging growth stocks. CCC benchmarked its large[-]cap portfolio holdings against the S&P 500 Index and its emerging growth portfolio holdings against the Russell 2000 Index. Securities held by CCC were all publicly traded. Market values for CCC's portfolio were readily available at nominal or no cost. Among the larger holdings in this widely diversified portfolio of marketable securities were Exxon, General Electric, Hewlett Packard, Microsoft, and Pepsico.

On the estate's Federal estate tax return filed on December 6, 1999, $4,588,155 was included in the gross estate as representing the value of decedent's 6.44-percent interest in CCC (which decedent held through his revocable trust). The estate computed the $4,588,155 value by reducing CCC's $188,635,833 net asset value by $51,626,884 for built-in capital gain tax liability and then applying 20-percent and 35-percent additional discounts to decedent's stock interest for lack of control and marketability, respectively.

In the notice of deficiency issued to the estate, respondent, among other things, determined that the value of decedent's 6.44-percent interest in CCC was

$9,111,111. Respondent indicated that this $9,111,111 value included "reasonable" discounts for lack of control and lack of marketability.

OPINION

The primary question presented for our consideration concerns the fair market value of an interest in a closely held family corporation. Decedent held (through a trust) a 6.44-percent minority interest in the corporation. The corporation in this case is a holding company with a portfolio of widely traded securities that have readily ascertainable values. Accordingly, the parties have agreed on the value of the subject corporation's assets. The controversy that remains involves the discounts or reductions from that agreed value. In addition to disagreement about control and marketability discounts, the parties differ as to the amount of the reduction from the value for the potential capital gain tax liability that would arise upon sale of the marketable securities held by the corporation. In particular, we must decide whether the value of the corporation should be reduced by the full amount of the built-in capital gain tax liability (as asserted by the estate) or by a lesser amount in which the reduction is based on the present value of the built-in capital gain tax liability discounted to reflect when it is expected to be incurred (as asserted by respondent).

A. *The Burden of Proof*

The estate contends that the burden of proof should shift to respondent under the provisions of section

7491(a)[3] on the issue considered by the Court.[4] Section 7491(a)(1) provides:

> If, in any court proceeding, the taxpayer introduces credible evidence with respect to any factual issue relevant to ascertaining the liability of the taxpayer for any tax imposed under subtitle A or B, the Secretary shall have the burden of proof with respect to such issue.

As a prerequisite to the shifting of the burden under section 7491(a) a taxpayer must: (1) Comply with statutory substantiation and record-keeping requirements, sec. 7491(a)(2)(A) and (B); (2) cooperate with reasonable requests by the Commissioner for "witnesses, information, documents, meetings, and interviews", sec. 7491(a)(2)(B); and (3) in cases of partnerships, corporations, and trusts, meet the net worth requirements set forth in section 7430(c)(4)(A)(ii), sec. 7491(a)(2)(C). Taxpayers bear the burden of showing that these requirements are met. *Higbee v. Commissioner* [Dec. 54,356], 116 T.C. 438, 440-441(2001); H. Conf. Rept. 105-599, at 240 (1998), 1998-3 C.B. 747, 994; S. Rept. 105-174, at 45 (1998), 1998-3 C.B. 537, 581.

The estate contends that it has complied with or met the requirements and that it has presented credible evidence in the form of its expert's report and the stipu-

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[3] All section references are to the Internal Revenue Code, and all Rule references are to the Tax Court Rules of Practice and Procedure, unless otherwise indicated.

[4] At trial, the estate filed a motion seeking to shift the burden to respondent. The Court intimated that it was not disposed to grant the estate's motion, but allowed the parties to further address this matter on brief. For the reason explained on the record and in this opinion, the estate's motion will be denied.

lated facts and exhibits. The evidentiary posture presented in this case is similar to that in *Estate of Deputy v. Commissioner* [Dec. 55,191(M)], T.C. Memo. 2003-176. No fact witnesses were called to testify in this case. As in *Estate of Deputy,* the parties here have stipulated the operative facts and documents, and the testimony presented at trial consisted of the cross-examination of the parties' tendered experts on their opinions on the question of value. In that regard, we note that the parties' experts' reports constitute *opinion* testimony, and such testimony is not *fact* for purposes of our ultimate findings. Accordingly, there exists no dispute about the underlying facts, and, ultimately, we are asked to decide the amount of reduction for built-in capital gain tax liability and the discounts for lack of marketability and control. In the setting of this case, those questions will be resolved on the basis of essentially agreed facts along with any assistance we may find helpful in the parties' experts' opinions, not on the basis of which party bears the burden of proof.

In such circumstances the question of who has the burden of proof or who should go forward with the evidence is irrelevant. See, e.g., *Estate of Hillgren v. Commissioner* [Dec. 55,555(M)], T.C. Memo. 2004-46; *Estate of Green v. Commissioner* [Dec. 55,384)], T.C. Memo. 2003-348; *Estate of Deputy v. Commissioner, supra.* Therefore, there is no need to decide whether the estate met the "credible evidence" requirement.

B. *CCC's Value on March 4, 1999*

The controversy presented for our decision concerns the value of a 6.44-percent interest in CCC, a corporation closely held by the Jelke family. For estate tax purposes, property includable in decedent's gross estate is

generally valued as of the date of death. See sec. 2001. The fair market value is determined by considering the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or to sell, and both having reasonable knowledge of relevant facts. Sec. 20.2031-1(b), Estate Tax Regs. The determination of the fair market value of property is a factual determination, and the trier of fact must weigh all relevant evidence of value and draw appropriate inferences. *Helvering v. Natl. Grocery Co.* [38-2 USTC ¶ 9312], 304 U.S. 282, 294 (1938); *Symington v. Commissioner* [Dec. 43,467], 87 T.C. 892, 896 (1986); sec. 20.2031-1(b), Estate Tax Regs.

The determination of the fair market value of a closely held (unlisted) stock may be effectively established by reference to arm's-length sales of the same stock within a reasonable time before or after the valuation date. See, e.g., *Ward v. Commissioner* [Dec. 43,178], 87 T.C. 78, 101 (1986). Absent an arm's-length sale, fair market value is normally determined using the hypothetical willing buyer and seller model. *Estate of Hall v. Commissioner* [Dec. 45,484], 92 T.C. 312, 335-336 (1989). Implicit in that model is the axiom that the seller would attempt to maximize profit and the buyer to minimize cost. *Estate of Curry v. United States* [83-1 USTC ¶ 13.518], 706 F.2d 1424, 1429 (7th Cir. 1983); *Estate of Newhouse v. Commissioner* 94 T.C. 193 (1990).

The particular aspect of the valuation question we consider here concerns the reduction for potential tax liability for gains "built in" to the securities held in CCC's corporate solution. The estate contends that the market value of CCC's holdings should be reduced by the entire amount of the built-in capital gain tax liability

that would be due if all of the assets (securities) were sold as of decedent's date of death. Respondent, admitting that there should be a discount or reduction,[5] contends that the potential tax liability should be discounted in accordance with time value of money principles.

The estate attempts to support its position through an expert who purports to use a net asset approach to valuation, which the estate contends requires an assumption of liquidation on the valuation date.[6] The estate relies on the rationale of an appellate court to which appeal would not normally lie in this case. Respondent attempts to support his position through an expert who contends that an assumption of liquidation is not appropriate in this case and that the tax liability for the capital gain should be calculated on the basis of CCC's established history of securities turnover. We agree with respondent. However, before we delve into the parties' arguments and their experts' opinions, it is helpful to review the legal history of the effect of built-in capital gain tax liability in the valuation of corporations.

Before 1986, this Court recognized that gain on appreciated corporate assets could be avoided at the cor-

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[5] Because the built-in capital gain tax liability is a corporate liability, it *reduces* the total value of the corporation. The parties here and some courts have described the built-in capital gain tax liability as something to be considered in the process of discounting the value of the interest being valued. In this case we treat the built-in capital gain tax liability as a liability that reduces the value of the assets before the consideration of discounts from the value of the interest for lack of control or marketability.

[6] If CCC were liquidated on the valuation date, it would essentially be selling readily marketable securities that would result in long-term capital gains and tax liability thereon.

porate level under the principles of the *General Utilities* doctrine.[7] That doctrine was based on the holding in *Gen. Utils. & Operating Co. v. Helvering* [36-1 USTC ¶ 9012], 296 U.S. 200 (1935), that there would be no recognition by the distributing corporation of inherent gain on appreciated corporate property that was distributed to shareholders. Accordingly, a corporation could distribute its appreciated property to shareholders or liquidate without paying capital gain tax at the corporate level.

On the basis of that understanding and before 1986, this Court consistently rejected taxpayers' attempts to discount the value of a corporation on the basis of any inherent capital gain tax liability on appreciated corporate property. See, e.g., *Estate of Piper v. Commissioner* [Dec. 36,315], 72 T.C. 1062, 1087 (1979); *Estate of Cruikshank v. Commissioner* [Dec. 15,941], 9 T.C. 162, 165 (1947). Indeed, only in rare instances before the repeal of the *General Utilities* doctrine did courts consider a built-in tax liability in deciding the value of a corporation. See, e.g., *Obermer v. United States* [65-1 USTC ¶ 12,280], 238 F. Supp. 29, 34-36 (D. Hawaii 1964).

Since the repeal of the *General Utilities* doctrine, this Court has, on several occasions, considered the impact of built[-]in capital gain tax liability in valuing corporate shares. Our approach to adjusting value to account for built-in capital gain tax liability has varied and has often been modified or overruled on appeal. See, e.g., *Estate of Davis v. Commissioner* [Dec. 52,7641], 110 T.C. 530, 552-554 (1998); *Estate of Dunn v. Commis-*

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[7] The *General Utilities* doctrine, as codified in former secs. 336 and 337, was repealed by the Tax Reform Act of 1986, Publ. L. 99-514, sec. 631(a), 100 Stat. 2269.

sioner [Dec. 53,713(M)], T.C. Memo. 2000-12, revd. [2002-2 USTC ¶ 60,446] 301 F.3d 339 (5th Cir. 2002); *Estate of Jameson v. Commissioner* [Dec. 53,247(M)], T.C. Memo. 1999-43, revd. [2001-2 USTC ¶ 60,420] 267 F.3d 366 (5th Cir.2001); *Estate of Welch v. Commissioner* [Dec. 52,689(M)], T.C. Memo. 1998-167, revd. without published opinion [2000-1 USTC ¶ 60,372] 208 F.3d 213 (6th Cir. 2000); *Eisenberg v. Commissioner* [Dec. 52,321(M)], T.C. Memo. 1997-483, revd. [98-2 USTC ¶ 60,322] 155 F.3d 50 (2d Cir. 1998); *Gray v. Commissioner* [Dec. 51,870(M)], T.C. Memo. 1997-67.

In one case, we held that a discount for built-in capital gain tax liability was appropriate because even though corporate liquidation was unlikely, it was not likely the tax could be avoided. See *Estate of Davis v. Commissioner, supra.* However, this Court has not invariably held that discounts or reductions for built-in capital gain tax liability were appropriate where it had not been shown that it was likely the corporate property would be sold and/or that the capital gain tax would be incurred. See, e.g., *Estate of Welch v. Commissioner, supra; Eisenberg v. Commissioner, supra; Gray v. Commissioner, supra.*

Appellate courts in two of these cases reversed our decisions that a reduction in value for built-in capital gain tax liability was inappropriate. The Court of Appeals for the Second Circuit reasoned that, although realization of the tax may be deferred, a willing buyer would take some account of the built-in capital gain tax. *Eisenberg v. Commissioner* [98-2 USTC ¶ 60,3221], 155 F.3d at 57-58. Likewise, the Court of Appeals for the Sixth Circuit disagreed with our specific holding that the potential for a capital gain tax liability was too specula-

tive. *Estate of Welch v. Commissioner, supra.* The Court of Appeals for the Sixth Circuit, to some extent, agreed with the Court of Appeals for the Second Circuit's approach in *Eisenberg.* Neither the Court of Appeals for the Second Circuit nor the Court of Appeals for the Sixth Circuit prescribed the amount of reduction or a method to calculate it.

The Commissioner has since conceded the issue of whether a reduction for capital gain tax liability may be applied in valuing closely held stock by acquiescing to the Court of Appeals for the Second Circuit's decision in *Eisenberg.* See 1999-1 C.B. xix. In addition, in this case the parties agree and we hold that a reduction for built-in capital gain tax liability is appropriate. However, controversy continues with respect to valuing such a reduction. In two such cases involving the question of valuing reductions for built-in capital gain tax liabilities, the Court of Appeals for the Fifth Circuit has reversed our holdings. See *Estate of Dunn v. Commissioner, supra; Estate of Jameson v. Commissioner, supra.*

In *Estate of Jameson,* the decedent held a controlling interest in a corporation that generated income primarily through the sale of appreciated timber. The corporation in *Estate of Jameson* focused on future appreciation in value, and there was no intent to liquidate the corporation as of the valuation date. This Court held that the fair market value was best determined using the asset approach because the company was a holding company rather than an operating company. We also held that the net asset value should be reduced for built-in capital gain tax liability because of a section 631(a) election that ensured that gain would be recognized irrespective of whether the corporation was liquidated. We further

held that the amounts of capital gain tax to be recognized in future years were to be discounted to present values by assuming a 14-percent overall rate of return and a 20-percent discount rate of future cashflows.

The Court of Appeals for the Fifth Circuit reversed our holding, commenting that the application of a 20-percent discount rate while assuming no more than a 14-percent annual growth was "internally inconsistent". *Estate of Jameson v. Commissioner* [2001-2 USTC ¶ 60,420], 267 F.3d at 372. The Court of Appeals also pointed out that, in its view, an assumption that a hypothetical buyer would operate a company whose expected growth was less than the buyer's required return was fatally flawed. *Id.*

In *Estate of Dunn v. Commissioner, supra*, the decedent owned a majority interest in a corporation primarily engaged in renting out heavy construction equipment. This Court, in deciding the value of the corporation, assumed that a hypothetical buyer and seller would give substantial weight to an earnings-based approach because the corporation was an operating company. This Court also gave some weight to an asset-based approach because the corporation's earnings projections were based on an atypically poor business cycle that would have produced an unreasonably low value. In accord with that reasoning, this Court used a 35-percent/65-percent combination of a cashflow earnings-based approach and an asset-based approach, respectively, to value the company. By using that combination of the two approaches, we rejected the estate's expert's sole reliance on an asset-based approach, where he assumed a liquidation on the valuation date and reduction for the entire amount of potential built-in capital gain

tax liability. Although the capital gain tax rate at the corporate level was 34 percent, this Court used a 5-percent reduction for the built-in capital gain tax liability in the asset-based portion of the value computation to account for the lower likelihood of liquidation.

The Court of Appeals for the Fifth Circuit, in reversing our holding in *Estate of Dunn*, held that the use of an asset-based approach to value assets generally assumes a sale of all corporate assets or a liquidation of the corporation on the valuation date, requiring a dollar-for-dollar reduction for the entire built-in capital gain tax liability as a matter of law. *Estate of Dunn v. Commissioner* [Dec. 53,713(M)], 301 F.3d at 351-353.[8] The Court of Appeals also concluded that the likelihood of liquidation had no place in a court's decision as to whether there should be a reduction for built-in tax liability under either the asset-based approach or the earnings-based approach. *Id.* at 353-354. The Court of Appeals did indicate, however, that the likelihood of liquidation would be relevant in assigning relative weights to the asset and earnings approaches where both methods would be used to determine value. *Id*. at 354-357.

With that background, we proceed to consider the circumstances and arguments in this case. The estate reported $4,588,155 as the discounted value of the CCC interest. Respondent determined that the discounted value of the CCC interest was $9,111,111. Although the estate's expert, Mr. Frazier, concluded that the discounted value of the CCC interest was $4,301,000, the estate is not seeking a value less than that reported on the es-

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[8] However, the Court of Appeals for the Fifth Circuit stated that consideration of built-in capital gain would be inappropriate in an earnings-based approach to value.

tate tax return. Likewise, respondent relies on his expert's, Mr. Shaked's, discounted value of $9,225,837 but does not seek to increase the amount determined in the notice of deficiency.

We are not constrained to follow an expert's opinion where it is contrary to the Court's own judgment, and we may adopt or reject expert testimony. *Helvering v. Natl. Grocery Co.* [38-2 USTC ¶ 9312], 304 U.S. at 295; *Silverman v. Commissioner* [76-2 USTC ¶ 13,148], 538 F.2d 927, 933 (2d Cir. 1976) (and cases cited thereat), affg. [Dec. 32,831] T.C. Memo. 1974-285.

In attempting to value the interest in CCC, the estate's expert, Mr. Frazier, considered the three traditional valuation approaches—income, market, and asset. Under the income approach, value is determined by computing a company's income stream. Under the market approach, value is determined by comparison with arm's-length transactions involving similar companies. Finally, under the asset approach, value is determined by computing the aggregate value of the underlying assets as of a fixed point in time.

After discussing several methods, Mr. Frazier used what he described as a combination of the market and asset approaches. Mr. Frazier used the market approach to value CCC's securities. Purporting to rely on the asset approach to valuation, Mr. Frazier then reduced the total of the market prices for CCC's securities by the liabilities shown on CCC's books and the tax liability that would have been incurred if all of CCC's securities had been sold on decedent's date of death. Mr. Frazier did not make adjustments to the tax liability for the possibility that sales of CCC's securities would have occurred after decedent's date of death. In other words,

Mr. Frazier relied on the net asset method to employ an assumption of liquidation as of the valuation date, an event which would trigger recognition of $51,626,884 in capital gain tax. This method produced a $137,008,949 million value for CCC. Mr. Frazier then computed an undiscounted value of $8,823,062 for decedent's 6.44-percent interest (3,000 of 46,585.51 shares) held in trust.

Respondent's expert, Mr. Shaked, started with the same market value of CCC's securities. Mr. Shaked then reduced the assets by liabilities, but he used a different approach from Mr. Frazier's in arriving at a reduction for the built-in capital gain tax liability. First, he computed CCC's average securities turnover by reference to the most recent data (1994-98). Using that data, Mr. Shaked computed a 5.95-percent average annual turnover derived from the parties' stipulated asset turnover rates for 1994-98. Mr. Shaked believed that the 5.95-percent rate was conservative,[9] because the turnover trend was generally decreasing. The use of the 5.95-percent turnover rate results in the capital gain tax's being incurred over a 16.8-year period (100 percent divided by 5.95 percent).

Mr. Shaked then divided the $51,626,884 tax liability by 16 years to arrive at the average annual capital gain tax liability that would have been incurred each year over this 16-year period—$3,226,680.25 ($51,626,884 divided by 16). Next, he selected a 13.2-percent discount rate based on the average annual rate of return for large-cap stocks in the period from 1926 to 1998, as described in Ibbotson Associates Stocks, Bonds, Bills & Inflation, 1999 Yearbook (Ibbotson 1999). He then com-

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[9] The use of a higher turnover rate would increased capital gain tax and decrease the value of decedent's CCC shares.

puted the present value of the $3,226,680.25 annual tax liability discounted over 16 years using a 13.2-percent interest rate to arrive at a present value for the total capital gain tax liability of $21,082,226. By reducing the $188,635,833 net asset value by the $21,082,226 future tax liability, Mr. Shaked arrived at a $167,553,607 value for CCC.

Finally, Mr. Shaked concluded that the undiscounted value for decedent's 6.44-percent interest in CCC was $10,789,164 in contrast to Mr. Frazier's undiscounted value of $8,823,062. This difference reflects numerically the parties' differing approaches to the amount of capital gain tax that should be used to reduce the net asset value of CCC.

A hypothetical buyer of CCC is investing in a composite portfolio to profit from income derived from dividends and/or appreciation in value. A hypothetical buyer of CCC is, in most respects, analogous to an investor/buyer of a mutual fund. The buyer is investing in a securities mix and/or performance of the fund and would be unable to liquidate the underlying securities. That is especially true here where we consider a 6.44-percent investor who, inherently, is unable to cause liquidation.[10] In addition, the record reveals that there was no intention of the trusts or the Jelke family shareholders to liquidate. A hypothetical buyer of a 6.44-percent interest in CCC is in effect investing in the potential for future earnings from marketable securities. A hypotheti-

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[10] Even if we were considering the value of a majority interest in CCC, a hypothetical buyer would not purchase the shares and then sell the stock to realize the net asset value, less the built-in capital gain tax liability. All of the securities held by CCC could have been acquired on the open market without built-in capital gains.

cal seller of CCC shares likewise would not accept a price that was reduced for possible tax on all built-in capital gain knowing that CCC sells or turns over only a small percentage of its portfolio annually. In that regard, the record reflects that CCC had a long-term history of dividends and appreciation, with no indication or business plan reflecting an intention to liquidate. In addition, as of the 1999 valuation date, one of the trusts holding CCC shares was designed so as not to terminate before 2019, and none of the CCC shareholders had sold or planned to sell their interests. These factors belie the use of an assumption of complete liquidation on the valuation date or within a foreseeable period after the valuation date.

The estate contends that its approach and assumption of complete liquidation is supported by the holding in *Estate of Dunn v. Commissioner* [2002-2 USTC ¶ 60,464], 301 F.3d 339 (5th Cir. 2002). In particular, the estate argues that the holding of the Court of Appeals for the Fifth Circuit requires that an asset-based approach (as opposed to an income approach) include the assumption that the assets were sold on the valuation date, regardless of whether the company was contemplating liquidation. Accordingly, the estate argues that the value of CCC should be reduced by the entire $51,626,884 tax liability for built-in capital gain.

The case we consider here would not normally be appealable to the Court of Appeals for the Fifth Circuit. We are not bound by or compelled to follow the holdings of a Court of Appeals to which our decision is not appealable. See *Golsen v. Commissioner* [Dec. 30,049], 54 T.C. 742 (1970), affd. [71-2 USTC ¶ 9497] 445 F.2d 985 (10th Cir. 1971). More significantly, there is some question

whether the Court of Appeals for the Fifth Circuit would require a liquidation assumption when valuing a minority interest. In that regard, the Court of Appeals tempered its holding in *Estate of Dunn* by explaining that if it were valuing a minority ownership interest, a business-as-usual assumption or earnings-based approach may be more appropriate. See *Estate of Dunn v. Commissioner* [2002-2 USTC ¶ 60,446], 301 F.3d at 353 n. 25.

The Court of Appeals' reasoning and holding in *Estate of Dunn* applied to a majority interest. There is no need to express agreement or disagreement with the automatic use of an assumption of liquidation when using an asset-based approach to value a majority interest, because we are valuing a small minority interest. To that extent, our holding here may be factually and legally distinguishable from the holding in *Estate of Dunn*. Accordingly, and unlike the situation in *Estate of Dunn*, decedent's 6.44-percent interest in CCC would be insufficient to cause liquidation.

The estate also argued that CCC's relatively low earnings and modest dividends would cause a hypothetical buyer to prefer liquidation. We are unpersuaded by the estate's supposition, which is contradicted by the record in this case. CCC performed well and kept pace with the S&P 500, defying the notion that it is an underperforming company. An investor may seek gain from dividends, capital appreciation, or a combination of the two. Accordingly, we hold that neither the circumstances of this case nor the theory or method used to value the minority interest in CCC requires an assumption of complete liquidation on the valuation date.[11]

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[11] We also note that we do not assume a rate of return lower than our discount rate, as we were said to have done in *Estate of Jameson v.*

Having held that an assumption of complete liquidation on the valuation date does not apply in this case, we must consider the amount of the reduction to be allowed for the built-in capital gain tax liability. Respondent's expert began with the total amount of built-in capital gain tax liability ($51,626,884); and after determining when the tax would be incurred, he discounted the potential tax payments to account for time value principles. The estate attacks that approach by contending that CCC's securities will appreciate, increasing the future tax payments and thereby obviating the need to discount.

The estate's expert, in an effort to support this theory, testified that if the premise is that the liquidation or sale of substantially all of a corporation's assets would occur in the future, there should also be:

> a long term projection * * * that the stock will appreciate. If the stock appreciates, the capital gains tax liability will appreciate commensurate [sic]. The present value of the capital gains tax liability will be the same. Only if you assume there's no appreciation in the stock would you discount the capital gains tax. And that's a completely unreasonable assumption.

Thus, the estate through its expert, Mr. Frazier, contends that irrespective of the unlikelihood of liquidation there should be a dollar-for-dollar decrease for the built-in capital gain tax liability, representing the present value of that liability because the liability will increase over time. In that regard, the estate argues that

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Commissioner [2001-2 USTC ¶60,420], 267 F.3d 366, 372 (5th Cir. 2001), revg. [Dec. 53,247(M)] T.C. Memo. 1999-43. Accordingly, our assumption of continuing operations is not "internally inconsistent." *Id.*

Mr. Shaked incorrectly assumed that the stock would not appreciate.

In addressing this argument, Mr. Shaked explained that the need to discount the built-in capital gain tax liability is analogous to the need to discount carryforward losses because they cannot be used until years after the valuation year. Mr. Shaked's approach is to calculate the built-in capital gain tax liability by determining when it would likely be incurred. We agree with Mr. Shaked's approach of discounting the built-in capital gain tax liability to reflect that it will be incurred after the valuation date.

Because the tax liabilities are incurred when the securities are sold, they must be indexed or discounted to account for the time value of money. Thus, having found that a scenario of complete liquidation is inappropriate, it is inappropriate to reduce the value of CCC by the full amount of the built-in capital gain tax liability. See *Estate of Davis v. Commissioner* [Dec. 52,764], 110 T.C. at 552-553.[12] If we were to adopt the estate's reasoning and consider future appreciation to arrive at subsequent tax liability, we would be considering tax (that is not "built in") as of the valuation date. Such an approach would establish an artificial liability. The estate's approach, if used in valuing a market-valued security with a basis equal to its fair market value, would, in effect, predict its future appreciated value and tax liability and then reduce its current fair market value by the present value of a future tax liability.

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[12] See also Bittker & Lokken, Federal Taxation of Income, Estates and Gifts, par. 135.3.8, at 135-149 (2d ed. 1993 and supp. 2004)

In that same vein, the estate argues that the Government, in other valuation cases, has offered experts who computed the capital gain tax on the future appreciated value of assets and discounted the tax to a present value for purposes of valuing a corporation. In one of those cases, the Court was valuing a corporation that owned rental realty (shopping centers). *Estate of Borgatello v. Commissioner* [Dec. 54,788(M)], T.C. Memo. 2000-264. As part of a weighting of factors to arrive at a discount, the Commissioner's expert calculated the potential for appreciation in the real estate market and the amount of built-in capital gain tax liability. This Court, to some extent, relied on the expert's methodology in its holding on value. In the other case relied upon by the estate, although the Commissioner's expert advanced a similar analysis, this Court rejected that expert's approach as an unsubstantiated theory. *Estate of Bailey v. Commissioner* [Dec. 54,788(M)], T.C. Memo. 2002-152.

The guidance of the expert was rejected in one of the cases cited by petitioner and was part of a discounting approach to assist the finder of fact (Court) to decide upon a discounted value in the other case. Although the expert's guidance in the latter case was considered in reaching a factual finding, the expert's approach does not represent the ratio decidendi of the case. In our consideration of the value of the marketable securities in this case, we are not bound to follow the same approach used by an expert in other cases. More significantly we do not find that approach to be appropriate in this case. Therefore, we find that in valuing decedent's 6.44-percent interest, CCC's net asset value need not be reduced by the entire $51,626,884 potential for built-in capital gain tax liability and that future appreciation of stock need not be considered. We find Mr. Shaked's use

of a 13.2-percent discount rate to be reasonable.[13] In addition, the turnover rate of securities used by Mr. Shaked is conservative and reasonable under the circumstances. The asset turnover rate reasonably predicts the period over which the company's assets will be disposed of and thus built-in capital gain tax liability would likely be incurred. Consequently, we find it appropriate to use a 16-year period of recognition for the tax liability attributable to the built-in capital gain. We therefore accept Mr. Shaked's computation arriving at a $3,226,680.25 annual tax liability and a discounted total liability of $21,082,226.

We accordingly hold that the undiscounted value of CCC on the date of decedent's death was $167,553,607 ($188,635,833-$21,082,226). This holding results in an 11.2-percent reduction in value for built-in capital gain tax liability ($21,082,226 divided by $188,635,833 equals 11.2 percent).

C. ***Discounts To Be Applied***

1. *Discount for Lack of Control*

Decedent's 6.44-percent (minority) interest in CCC must be discounted for lack of control. The estate's expert, Mr. Frazier, discounted decedent's CCC interest by 25 percent for lack of control. Respondent's expert, Mr. Shaked, applied a 5-percent discount.

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[13] We recognize that a discount rate would normally be a matter of negotiation between a willing buyer and seller. The estate, in its post-trial briefs, agrees that Mr. Shaked's discount rate is an appropriate rate if we were to discount the built-in capital gain tax liability. Because the estate agrees with this rate and the parties have provided no further evidence with regard to a discount rate, we give no further consideration to this matter.

Mr. Frazier compared CCC to a closed-end and not widely traded investment fund holding publicly traded securities. He believed that CCC and a closed-end fund both have a fixed amount of assets for trading, unlike open-end investment funds (mutual funds). Because closed-end funds are flowthrough entities taxed only at the shareholder level, Mr. Frazier concluded that the discounts reflected in those funds did not include any reduction for built-in capital gain tax liability. Likewise, because closed-end funds are typically publicly traded, none of the discount inherent in those funds would be attributable to lack of marketability.

With those assumptions, Mr. Frazier reviewed 44 domestic equity security funds and selected 15 that he believed were comparable. He removed eight companies from the 15 because, unlike CCC, they had guaranteed payouts. The remaining seven companies had an average discount rate of 14.8 percent as of March 4, 1999. The funds' discounts and returns compared with those of CCC, as computed by Mr. Frazier, are reflected in the following table:

		Market Total Return			
Company	*Discount*	*3-month*	*1-year*	*3-year*	*5-year*
Morgan Grenfell	19.2%	39.3%	45.5%	18.4%	22.1%
Central Securities	17.3	17.0	23.9	13.9	21.7
Tri-Continental	17.3	4.9	11.2	21.4	22.7
Adams Express	17.2	17.5	27.6	26.4	24.9
Royce Micro Cap	17.0	8.7	4.1	8.4	11.7

General American Inv.	8.5	24.2	38.7	37.1	30.0
Salomon Bros.	7.3	23.6	34.7	28.8	33.8
Average	14.8	19.3	26.5	22.1	23.8
75th percentile	17.3	23.9	36.7	27.6	27.5
Median	17.2	17.5	27.6	21.4	22.7
CCC	25.0	6.0	17.8	25.1	22.9

Next, Mr. Frazier eliminated lower discounted funds (General American and Salomon Brothers) because he concluded the low discounts were due to the consistently high returns of those companies. Mr. Frazier believed that CCC's performance was most similar to those of the funds in the upper end of the discount spectrum (Morgan Grenfell, Central Securities, and Tri-Continental), because of CCC's inconsistent returns and small size. Finally, he concluded that CCC was comparable to Morgan Grenfell, because its assets were slightly less than CCC's and Central Securities' and Tri-Continental's assets were much larger.

Ultimately, Mr. Frazier concluded that an investor would demand a higher rate of return or a larger discount than for the comparable companies, because: (1) CCC had fewer assets than almost all comparables; (2) CCC paid fewer dividends than the average of all comparable companies (excluding Morgan Grenfell, which did not pay dividends) but paid dividends in amounts similar to those of non-guaranteed-payout comparables; and (3) the companies without guaranteed dividend payouts, on average, outperformed CCC in the short term (3-month and 1-year returns). Mr. Frazier

compared CCC to the upper quartile of companies (Morgan Grenfell and Central Securities), noting that the average discount rate was 18.3 percent and the performance was as follows:

	3 Months	*1 year*	*3 years*	*Additions to tax*
Upper Quartile	28.1%	34.7%	16.2%	21.9%
CCC	6.0%	17.8%	25.1%	22.9%

In the final analysis, Mr. Frazier concluded that a hypothetical buyer would seek a lack-of-control discount of 25 percent, which comprised 20 percent on the basis of the comparables he selected and an additional 5 percent because of other less significant dissimilarities with CCC.

In contrast, Mr. Shaked applied a 5-percent discount for lack of control. His analysis began with an average discount (8.61 percent) for closed-end funds that he obtained from an article in the Journal of Economics. Mr. Shaked considered CCC a well-managed holding company with a diversified portfolio of marketable securities. Accordingly, he believed that management decisions, which are more critical in certain types of operating companies, were less relevant and that a hypothetical buyer/investor of CCC stock would be less concerned about lack of control. It was also Mr. Shaked's view that an investor in CCC, much like investors of mutual funds, would prefer not to have control, making a lack-of-control discount less significant. In that regard, Mr. Shaked noted that the beneficial owners of the shares of CCC were not managers of CCC or members of its board of directors.

Both experts agreed that there was an inverse relationship between a company's financial performance and a lack-of-control discount. In other words, as performance improves the discount decreases. The parties, however, disagree about CCC's performance. Respondent argues that CCC outperforms many of the 15 comparables used by Mr. Frazier, if considered over a 3-, 5- and 10-year period. Conversely, the estate, for the same period, argues that CCC has underperformed the S&P 500 and most of the final seven comparables selected by Mr. Frazier. We believe that CCC has a good performance record. Accordingly, we agree to some extent with Mr. Shaked's observation that control would be less important for CCC.

Mr. Shaked, in support of his 5-percent discount for lack of control, provided the generalized explanation that CCC was similar to a closed-end holding company. Mr. Frazier provided more detail and analysis in support of his 25-percent discount for lack of control, but some of his analysis overlooks important aspects and, to some extent, is inconsistent.

First, Mr. Frazier's reasoning in using some of the comparables is flawed. He did not provide adequate justification for eliminating Tri-Continental and Adams Express as comparables. In addition, he ignored the fact that Royce Micro Cap and Morgan Grenfell Smallcap held investments in small-cap funds and that Central Securities Corp. held less diversified investments. Both strategies would appear riskier than CCC's strategy of investing in a diversified base of large-cap stocks and limiting its holdings to no more than 25 percent of its total assets in a single industry. CCC's investment strategy was more comparable to that of a diversified stock

fund like Salomon Brothers Fund, which invested in listed NYSE securities. We note that in Mr. Frazier's analysis, Salmon Brothers Fund was discounted only 7.3 percent.

We also note that Mr. Frazier did not justify or adequately explain why he limited his comparison to the two funds with the highest discounts (18.3-percent average). We find it curious that his analysis purports to compare CCC to either three or seven companies, when actually the final universe he selected was smaller. We also note that Mr. Frazier did not explain or justify increasing the discount rate from the 18.3-percent average of these two to 20 percent. Finally, though Mr. Frazier did show that CCC's short-term rate of return was lower than those of the selected companies, CCC had a long-term investment strategy and, on average, out-performed the comparables in that respect.

In addition, we are unable to agree with Mr. Frazier's assumption that the discounts reflected in the comparable companies he selected are due solely to lack of control. Part of the discount may be due to lack of marketability. In that regard, Mr. Frazier acknowledges that "lack of the ability to liquidate [is an] investment characteristic shared by * * * publicly-traded closed-end investment funds [and] closely[-]held corporations." Lack of liquidity, however, is a marketability factor and should not be considered in connection with lack of control. Further, other factors relating to the comparables could cause them to trade at a discount, such as a riskier investment strategy as described above, uncertain management, or some company-specific risk.[14]

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[14] For example, some funds that have above-average performance trade at a premium, indicating that even though investors do not control

Nevertheless, we generally agree that there are similarities between closed-end funds and CCC. Like CCC, closed-end funds operate with a finite amount of capital, and they cannot increase or decrease the size of their portfolios. This reduced flexibility in comparison to traditional mutual funds may warrant some discount in price for the increased risk, and although it is difficult to categorize this discount, it could fit within the concept of lack of control. However, it is difficult to quantify the amount of discount that is attributable to lack of control.

Although we are not convinced that the discounts reflected in the funds Mr. Frazier compared to CCC were due solely to lack of control, we note that Tri-Continental, Adams Express, General American, and Salomon Brothers had investment strategies similar to CCC's. CCC's focus was long-term capital growth and it did not have a guaranteed dividend payout. However, the amount of discount in these comparable funds that is due to lack of control, rather than some other factor, is speculative. We also note that while CCC performed well, it did not perform as well as some of the comparables. In addition, CCC was relatively small compared to the comparable investment funds. CCC had a $167 million value compared to billions of dollars in many of the comparables.

On the other hand, CCC was well diversified, reducing the investment risk. In addition, investors in CCC would be less inclined to desire control because of the passive nature of an investment in this kind of company

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closed-end funds, some company-specific factors such as an expectation of future performance are considered in the fund's price relative to its net asset value. See Malkiel, "The Valuation of Closed-End Investment Company Shares". J. Fin. 851 (June 1977).

and its established long-term performance of good returns. Considering all of these factors, we hold that a 10-percent lack-of-control discount is appropriate.

2. *Discount for Lack of Marketability*

A discount for lack of marketability addresses liquidity or the ability to convert an asset into cash. See, e.g., *Mandelbaum v. Commissioner* [Dec. 50,687(M)], T.C. Memo. 1995-255, affd. [96-2 USTC ¶ 60,240] 91 F.3d 124 (3d Cir. 1996). When valuing stock, we assume that the buyer and seller each have "reasonable knowledge of the relevant facts." Sec. 20.2031-1(b), Estate Tax Regs.

Mr. Frazier used a 35-percent and Mr. Shaked used a 10-percent discount for lack of marketability. Mr. Frazier considered studies of operating companies with a minimum restriction on resale of at least 2 years. Although he acknowledged that operating companies are inherently riskier than holding companies, Mr. Frazier believed that the marketability discount for CCC was comparable to those of operating companies because CCC was not expected to liquidate for at least 20 years.[15] He relied on Rev. Rul. 77-287, section 6.02, 1977-2 C.B. 319, 321-322, for the proposition that "the longer the buyer of the shares must wait to liquidate the shares, the greater the discount."

Mr. Frazier believed that the studies he considered showed that the following factors were relevant to a

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[15] We must note that Mr. Frazier reduces CCC's asset value by the entire $51,626,884 built-in capital gain tax liability on the assumption of a liquidation on the valuation date, whereas for purposes of his lack of marketability analysis he relies on the premise that CCC will not be liquidated for at least 20 years. In each instance, the approaches, although internally inconsistent, produce the best results for his client (the estate).

marketability discount: Company revenues, company profitability, company value, the size of the interest being valued, the company's dividend policy, whether the company is an operating or investment company, and the likelihood the company will go public. On the basis of CCC's value, revenues, profitability, and the size of the interest being valued, Mr. Frazier observed that comparable discounts ranged anywhere from 14 percent to more than 35 percent. Mr. Frazier believed that CCC's dividend-paying policy and the fact it was an investment company favored an average to below-average discount, while the long 20-year holding period of CCC shares and the fact that there was no likelihood of CCC's going public favored a higher discount for CCC. On the basis of an analysis of all these factors, Mr. Frazier applied a 35-percent discount rate for lack of marketability.

Mr. Shaked applied a 10-percent discount rate based on his analysis of the factors described in *Mandelbaum v. Commissioner, supra.* The nine factors used in the *Mandelbaum* case to analyze the discount were: (1) Financial statement analysis, (2) dividend policy, (3) outlook of the company, (4) management of the company, (5) control factor in the shares to be purchased, (6) company redemption policy, (7) restriction on transfer, (8) holding period of the stock, and (9) costs of a public offering.

Mr. Shaked began his analysis with the assumption that 20 percent was an average discount and then applied the factors in the *Mandelbaum* case to arrive at a 10-percent discount. Mr. Shaked considered the fact that the securities held by CCC were readily marketable in arriving at his discount. He believed that CCC's

well-diversified portfolio resulted in low price volatility and was a factor in applying a low discount for marketability. In addition, since CCC's assets were marketable securities, it would be easier to find a willing buyer for this company than for a riskier company whose performance was more speculative.

Respondent contends that Mr. Frazier's assessment of restrictions on transferability is misguided, arguing that an expectation not to liquidate for another 20 years is different from a restriction on transferability; and that while sales cannot take place in the public market, they can in the private market. Mr. Frazier's analysis was based on publicly traded securities with restrictions on resale to which the quotation from the revenue ruling referred. However, because CCC was a closely held company with no restrictions on transfer, investors would not be "locked" into this investment. Despite those important distinctions, restricted stock resales provide a limited amount of guidance on the question of lack of marketability. In particular, the studies concerned actual resales of the stock in a private market setting as compared to the price of publicly traded counterparts. Thus, while there were restrictions on selling the stock in a market transaction, there were no restrictions on private transfers.

Respondent contends that the companies examined in the restricted stock studies are not comparable because many of them were unprofitable or riskier than CCC. Mr. Frazier studied sales of stock of a number of companies. He acknowledges that a significant number of those companies reported a loss prior to the sale of that company's stock. Studies that focused on profitable companies, however, resulted in 22- to almost 35-percent

discounts, whereas the studies of unprofitable companies which respondent contends are not comparable had lower discounts ranging from 14 to 25 percent.

Finally and despite the estate's assertions to the contrary, respondent contends that there is a market for CCC shares. While none of the shareholders had a buyback agreement with CCC allowing them to have their shares redeemed, the minutes of CCC's board of directors indicate that the corporation did maintain a sufficient cash position in the event that the estate requested redemption of its shares. This, however, does not show that there is a public market for these shares, nor does it show that a hypothetical willing buyer would have a market for these shares.

We disagree with some of Mr. Shaked's analysis of the factors from the *Mandelbaum* case. The holding period of the CCC stock is different from the holding period of the underlying assets. Therefore, we find unfounded Mr. Shaked's assertion that the holding period of CCC stock is trivial because it can liquidate its assets (stock holdings). In addition, Mr. Shaked's discussion of the marketability of the underlying assets presents a different question from the marketability of CCC. An owner of CCC stock cannot purchase and sell securities in CCC's portfolio. Finally, the estate is correct in noting that consideration of the public offering factor should bear on the costs incurred if the company decided to go public. See *Mandelbaum v. Commissioner* [Dec. 50,687(M)], T.C. Memo. 1995-255. Therefore, Mr. Shaked's analysis on this factor was somewhat flawed.

Both parties make critical errors in their assumptions and analysis concerning the appropriate marketability discount. We generally find their analysis to be

only minimally helpful, and, accordingly, we use our own analysis and judgment, relying on the experts' or parties' assistance where appropriate. See *Helvering v. Natl. Grocery Co.*, 304 U.S. at 295 [38-2 USTC ¶ 9312]; *Silverman v. Commissioner* [76-2 USTC ¶ 13,148], 538 F.2d at 933.

We find the factors considered in *Mandelbaum v. Commissioner, supra,* to be a helpful guide to approaching the question of the amount of marketability discount. We are unable to give any weight to studies involving the companies Mr. Frazier deemed comparable, because they were not sufficiently similar to provide us with meaningful guidance regarding CCC. We do agree with respondent that CCC's financial performance justifies a lower-than-average discount for lack of marketability. The discount should be lower than average, even though CCC's dividends were lower than those of similar companies, because it had a successful history of long-term appreciation. Because CCC is a holding company with a diversified spectrum of marketable blue chip securities, its performance is relatively reliable and easily verified.

CCC's financial outlook should also favor a lower-than-average discount because there is no indication that CCC's portfolio or performance will change from its currently and historically successful course. CCC's management, as stipulated by the parties, has performed well, a factor in favor of a lower[-]than-average discount. The lack of control in the subject shares should not cause the discount to vary significantly from the average because a buyer of a 6.44-percent interest in CCC would not be interested in control. Because there

are no restrictions on the transferability of CCC shares, that factor would favor a lower-than-average discount.

The holding period for CCC stock would favor a higher-than[-]average discount because, absent a sale, some of the trusts holding shares cannot terminate in less than 20 years. In addition, because gain from the investment relies more heavily on long-term appreciation, that would also extend the necessary holding period to realize the investor's goals in such an investment. CCC has no redemption policy, although the board indicated that it would consider redeeming an individual shareholder's shares. Accordingly, it is uncertain whether redemption will occur, and the existence of such uncertainty warrants a somewhat higher than average discount. There is no reason to consider "the costs of going public" in the circumstances of this case.

Accordingly, the factors outlined in *Mandelbaum v. Commissioner, supra,* overall, favor a lower-than-average discount for lack of marketability. We hold that 15 percent is an appropriate discount for lack of marketability. This discount, coupled with the 10-percent discount for lack of control produces a 23.5-percent discount (1-(1-.10) (1-.15)).[16] Accordingly, we hold that the 3,000 shares of CCC had a discounted value of $8,254,696[17] on March 4, 1999, the date of decedent's death.

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[16] As already noted, the discounts reflected for the funds Mr. Frazier found to be comparable in his closed-end fund study may have reflected more than a lack of control discount.

[17] Fair market value of CCC of $167,553,607, times 6.44 percent interest equals $10,790,452, less 23.5 percent ($2,535,756) equals $8,254,696.

To reflect the foregoing,

An appropriate order will be issued, and decision will be entered under Rule 155.

APPENDIX C

IN THE UNITED STATES COURT OF APPEALS
FOR THE ELEVENTH CIRCUIT

No. 05-15549-CC

ESTATE OF FRAZIER JELKE, III, DECEASED,
WACHOVIA BANK, N.A. F.K.A. FIRST UNION NATIONAL
BANK, PERSONAL REPRESENTATIVE,
PETITIONERS-APPELLANTS

v.

COMMISSIONER OF INTERNAL REVENUE,
RESPONDENT-APPELLEE

[Dated: Feb. 21, 2008]

ON APPEAL FROM A DECISION OF
THE UNITED STATES TAX COURT

ON PETITION(S) FOR REHEARING AND PETITION (S) FOR REHEARING EN BANC

Before: TJOFLAT, CARNES and HILL, Circuit Judges.

PER CURIAM:

The Petition(s) for Rehearing are DENIED and no Judge in regular active service on the Court having requested that the Court be polled on rehearing en banc (Rule 35, Federal Rules of Appellate Procedure), the Petition(s) for Rehearing En Banc are DENIED.

ENTERED FOR THE COURT:

/s/ JAMES C. HILL
JAMES C. HILL
UNITED STATES CIRCUIT JUDGE

APPENDIX D

STATUTORY AND REGULATORY PROVISIONS INVOLVED

1. Section 2033 of Title 26, United States Code, provides:

Property in which the decedent had an interest

The value of the gross estate shall include the value of all property to the extent of the interest therein of the decedent at the time of his death.

2. Section 2031 of Title 26, United States Code, provides, in pertinent part:

Definition of gross estate

(a) General

The value of the gross estate of the decedent shall be determined by including to the extent provided for in this part, the value at the time of his death of all property, real or personal, tangible or intangible, wherever situated.

3. Section 20.2031-1 of Title 26, Code of Federal Regulations, provides in pertinent part:

* * * * *

(b) *Valuation of property in general.* The value of every item of property includible in a decedent's gross estate under sections 2031 through 2044 is its fair market value at the time of the decedent's death, except that if the executor elects the alternate valuation method under section 2032, it is the fair market value thereof at the date, and with the adjustments, prescribed in that

section. The fair market value is the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or to sell and both having reasonable knowledge of relevant facts. The fair market value of a particular item of property includible in the decedent's gross estate is not to be determined by a forced sale price. * * * All relevant facts and elements of value as of the applicable valuation date shall be considered in every case.

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4. Section 20.2031-2 of Title 26, Code of Federal Regulations, provides in pertinent part:

Valuation of stocks and bonds

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(f) *Where selling prices or bid and asked prices are unavailable.* If the provisions of paragraphs (b), (c), and (d) of this section are inapplicable because actual sale prices and bona fide bid and asked prices are lacking, then the fair market value is to be determined by taking the following factors into consideration:

(1) In the case of corporate or other bonds, the soundness of the security, the interest yield, the date of maturity, and other relevant factors; and

(2) In the case of shares of stock, the company's net worth, prospective earning power and dividend-paying capacity, and other relevant factors.

Some of the "other relevant factors" referred to in subparagraphs (1) and (2) of this paragraph are: The good will of the business; the economic outlook in the particular industry and its management; the degree of control

of the business represented by the block of stock to be valued; and the values of securities of corporations engaged in the same or similar lines of business which are listed on a stock exchange. However, the weight to be accorded such comparisons or any other evidentiary factors considered in the determination of a value depends upon the facts of each case. In addition to the relevant factors described above, consideration shall also be given to nonoperating assets, including proceeds of life insurance policies payable to or for the benefit of the company, to the extent such nonoperating assets have not been taken into account in the determination of net worth, prospective earning power and dividend-earning capacity. Complete financial and other data upon which the valuation is based should be submitted with the return, including copies of reports of any examinations of the company made by accountants, engineers, or any technical experts as of or near the applicable valuation date.

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